Expulsion or Oppression of Business Associates

EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES

"Squeeze-Outs" in Small Enterprises

Prepared by Duke University under the Small Business Administration Management Research Grant Program

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Duke University Press
Durham, N. C. *1961*

Library of Congress Catalog Card Number 61-16908
Cambridge University Press, London N.W.1, England

Printed in the United States of America
by the Seeman Printery, Inc., Durham, N. C.

Preface

This document reports on a study which is one of a series of investigations Duke University is making of the legal problems of small business. These studies are being prepared under the Management and Research Grant Program of the Small Business Administration.

The procedure followed in making this study was a combination of field work and library investigation believed to be almost unique in legal research. Selected small businessmen, lawyers, and various other business advisers—persons located in every section of the country—were asked to give information on actual cases in which some of the owners of an enterprise eliminated or tried to eliminate their associates from the business. They were also asked (1) to list legal devices and other arrangements which they had used or had seen used to protect against such squeeze-outs, and (2) to suggest legislative measures and other changes in legal controls which might better protect holders of minority interests and avoid squeeze-outs. Information received was sifted and analyzed; devices and arrangements suggested as serviceable in guarding against squeeze-outs were tested for legality and workability; and proposals for changes in the law were examined, keeping in mind the complex policy considerations involved.

A fault of this report may be that it tries to do too much. It is directed both to owner-managers of small businesses and to the legal specialists who serve them. Thus, in a sense this report "rides off in two directions," trying to set forth information on squeeze-outs in a readable, refreshing, and fairly concise style which will appeal to businessmen, and at the same time trying to include sufficient detail and discussion of legal authorities to provide a useful guide to lawyers handling squeeze-out problems.

To give appropriate individual acknowledgment to every person whose work and thought have gone into this study is impossible. A number of years ago Dean Elvin R. Latty of Duke University School of Law conceived the idea of compiling a comprehensive list

of squeeze-out techniques but never found time for the project. When Duke University received a grant from the Small Business Administration for studies of the legal problems of small business, Dean Latty suggested squeeze-out techniques as an appropriate and promising subject to study. When the subject was approved, he participated with enthusiasm in the planning of the study, and thereafter served as the principal consultant on it.

As has already been pointed out, small businessmen, lawyers, and other business advisers furnished much of the data and many of the ideas which have gone into this report. Leading members of the corporate bar in all parts of the country have been particularly generous in giving of their time and experience to talk with us and to answer our questions by letter. Thus, this report is in considerable part a distillation of the experience and thinking of some of the nation's most resourceful lawyers, businessmen, and business advisers.

My co-author, Jordan Derwin, now a member of the New York Bar, volunteered to handle the part of this report dealing with partnership squeeze-outs, an area in which I did not feel entirely at home. Thus he prepared all of Chapter VI and the parts of Chapters VII and VIII dealing with partnerships, as well as several sections in chapters dealing with corporate squeeze-outs. His skill in digging up useful information and in separating the important from the unimportant has made my work easier and this report more serviceable.

A number of other persons have rendered valuable service in research or in preparing the manuscript. Among them are the following: C. Edwin Chapman, who as a part-time research assistant and graduate student at the Duke University School of Law, participated in the basic research on this project; Thomas C. Brissey, L. Neil Williams, Jr., Roger S. Poore, and George A. Coltrane, all senior students at Duke University School of Law, who read and briefed many of the cases used in this study and checked the accuracy of authorities cited; Clark C. Havighurst, a research associate in the Duke University School of Law, who did a superior job of editing the four case histories set forth in the appendix; Morton Gitelman, a research associate in the Duke University School of Law, and Robert N. Davies, a senior student in the School of Law, who helped in preparing the final manuscript; and Mrs. Raymond

Patten, my secretary, whose capable and diligent efforts, often after hours, made it possible for us finally to put a report together.

Callaghan and Company has graciously permitted us to reprint in this book two rather extensive excerpts from my work on *Close Corporations: Law and Practice;* the editors of *Boston College Industrial and Commercial Law Review* have permitted the republication of excerpts from my article entitled "Oppugnancy and Oppression in Close Corporations: Remedies in America and in Britain"; and the Editors of *Duke Law Journal* have generously authorized use of material prepared by two members of the *Journal's* Board of Editors and first published in that periodical.

The Project Director

Durham, North Carolina

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Chapter 1. SCOPE OF STUDY, OBJECTIVES AND PRELIMINARY CONSIDERATIONS

§ 1.01. *Scope of study*

This paper is a study of squeeze-outs in small businesses. Its objectives are as follows: (1) to determine what squeeze-out techniques are in current use and what remedies are available to "squeezees," (2) to discover what are the underlying causes of squeeze-plays, (3) to evolve arrangements which under existing laws can be set up in advance (when participants are entering an enterprise) to protect them against squeeze-outs, and (4) to determine what changes can be made in existing laws and legal controls to protect participants in small businesses against squeeze-outs and assure prospective investors of equitable treatment by their business associates.

By the term "squeeze-out" is meant the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants.[1] This study also covers what might be termed "partial squeeze-outs," that is, action which reduces the participation or powers of a group of participants in the enterprise, or their claims on earnings or assets, or otherwise deprives them of business income or advantages to which they are entitled. A squeeze-out normally does not contemplate payment to the

[1] The term "freeze-out" is often used as a synonym for "squeeze-out."

squeezees of fair value for the interests, rights, or powers which they lose.

Perhaps the point needs to be made early, however, that the equities are not always on the side of the squeezee. Minority shareholders quite often are so unco-operative and act so unreasonably and improperly that majority interests are justified in moving to eliminate them. In some instances, obstreperous conduct by minority shareholders is prompted by a determination to compel majority shareholders to buy the minority interest at a price in excess of its value. Furthermore, minority shareholders not uncommonly consider themselves aggrieved when in fact they are being quite fairly treated. For example, the unhappiness of shareholders who believe they are being squeezed is sometimes attributable to the fact that they live at a distance from the place where the businesss is conducted, perhaps do not understand the business or its problems, and simply are not in a position to play leading roles in the conduct of the enterprise. Real squeeze-plays sometimes cannot easily be distinguished from cases of imagined injustices grounded in frustration or unrealistic expectations. In the mind of an unhappy shareholder there is often no clear-cut line between unpleasantness, dissension, or frustration on the one hand and oppression, injustice, or squeeze-out on the other.[2]

§ 1.02. *Relation of business form to squeeze-outs*

Squeeze-outs are most often effected in relatively small corporations (usually referred to as "close corporations"),[3] by majority shareholders who use the tremendous powers which they have under the principle of majority rule to eliminate minority interests. The partnership form and partnership law do not encourage complex or subtle squeeze-plays to anywhere near the same extent as do the corporate form and the legal concepts and principles applicable to

[2] See, e.g., Doherty v. Mutual Warehouse Co., 245 F.2d 609 (5th Cir. 1957); 255 F.2d 489 (5th Cir. 1958).

[3] The term "close corporation" has been defined in various ways. A definition quite frequently encountered describes the close corporation simply as a corporation which has relatively few shareholders, and thus distinguishes and sets apart the close corporation from the large public-issue or publicly held corporation. Another popular definition states that a close corporation is a corporation whose shares are not generally traded in the securities market. For other definitions and for a detailed discussion of the characteristics of the close corporation, see O'Neal, Close Corporations: Law and Practice, ch. I (1958).

it. Therefore, this study in large part focuses on squeeze-outs in close corporations. Nevertheless, some consideration is given squeeze-outs in partnerships.

§ 1.03. *The traditional corporate control pattern*

Perhaps a few words should be said at this point on the traditional pattern of corporation management. The principal control that shareholders have over operation of an incorporated business and the conduct of its affairs is power to elect directors, who in turn manage the business and make policy determinations. In addition, shareholder approval is now almost invariably required by statute for fundamental corporate acts such as charter amendments, consolidations, mergers, dissolution, and sale of all corporate assets.

As a general proposition, a corporation operates under the principle of majority rule: the holders of a majority of the shares with voting power control the corporation. This principle is modified somewhat in most states by statutory provisions which require for fundamental corporate acts the favorable vote of holders of two-thirds or three-fourths of the shares with voting power or the vote of the holders of a specified percentage of all shares irrespective of whether the shares are given voting rights by the corporation's charter.

The business of a corporation, at least all ordinary business, is conducted under the supervision of the board of directors. The directors in theory at least are supreme during their term of office (usually one year). They determine corporate policies and they select corporate officers and employees.

The power to elect the directors, or most of them, is in the persons holding a majority of the voting shares. In turn, action by the directors is normally determined by majority vote. In practice directors are usually responsive to the wishes of shareholders who elected them. Indeed, in most small business corporations, majority shareholders and their relatives constitute all or most of the directors.

Under this pattern of corporate control, majority interests can deprive minority interests of any effective voice in the operation of the business. Further, the danger is always present that majority

shareholders will use their power to further their own interests to the detriment of minority shareholders.

§ 1.04. *Losses and injustices to squeezees*

The losses which a minority shareholder suffers in a squeeze-out are sometimes catastrophic. As has already been mentioned, he may be deprived of any effective voice in the making of business decisions. Not only that, majority participants may be able to withhold from him information on the affairs of the business and on policies being adopted and decisions being made. In most states, no affirmative duty is imposed on majority shareholders, or the directors or officers whom they select, to furnish information to minority interests. A shareholder, it is true, has a common law or statutory right to inspect corporate books and records. Often, however, this right is frustrated because those in control of the corporation resort to long drawn-out litigation. They may force him to go to court each time he seeks to see the books.

Quite commonly when a participant invests in a small business he expects to work in the business on a full-time basis. He may put practically everything he owns into the business and expect to support himself from the salary he receives as a key employee of the company. Whenever a shareholder is deprived of employment by the corporation (as he frequently is in these squeeze-plays) he may be in effect deprived of his principal means of livelihood. Even in the absence of the deliberate use of dividend-withholding as a squeeze technique, a close corporation, in order to avoid so-called "double taxation," usually pays out most of its earnings in the form of salaries rather than as dividends.

A shareholder may also find that the investment he made in the enterprise has become practically valueless. As has been pointed out, dividends are seldom paid in close corporations; one of the most commonly used squeeze techniques is to withhold dividends from minority shareholders who are not employed by the company. Such a shareholder cannot withdraw the funds he has invested, and he cannot find a purchaser for his interest. Seldom can anyone be found who is willing to buy a minority interest in a close corporation, especially an interest in a company divided by bitter disputes.

All of this was summed up quite succinctly a few years ago by the Supreme Court of Ohio in the following language borrowed from an address delivered before a bar association back in 1893: "In a corporation represented by 100 shares of capital stock, the owners of 51 shares could manage the corporation without the voice of the remaining 49 shares being heard, and the one odd share would be the available power; the 51 shares might be made very valuable, while the 49 could be rendered valueless, and the odd share of the balance of power receive an immense value." That same court went on to repeat the old story, often told, of a prominent Eastern newspaperman's reply to the question of what the shares in his company were worth. His reply was quite apt. "There are 51 shares," said he, "that are worth $250,000. There are 49 shares that are not worth a —— ——."[4]

§ 1.05. *Losses to the economy*

There is no way of knowing the extent of the economic loss resulting from squeeze-outs. Obviously many small businesses are seriously damaged by bitter squeeze-out fights. Although statistics are not available, squeeze-outs and attempted squeeze-outs undoubtedly bring to thousands of small businesses each year friction and strife, impaired efficiency of key personnel, heavy loss of working hours, and expensive litigation.[5] Occasionally the strife, litigation, and unfavorable publicity arising out of a squeeze-out destroys an enterprise.

Perhaps most important, however, a potential source of much-needed risk capital for small business enterprises is threatened by the prevalence of squeeze-outs. Most small businesses depend largely upon individuals in the local community for risk capital. Certainly the frequency of squeeze-outs and the dire consequences to the squeezees have become well known to many prospective investors. Undoubtedly, some persons, because of the dangers of oppression in

[4] Humphrys v. Winous Co., 165 Ohio St. 45, 50, 133 N.E. 2d 780, 783 (1956), quoting address of John H. Doyle before Ohio State Bar Association in 1893.

[5] See Calder, Cases in the Management of Small, Family-Controlled Manufacturing Businesses, in Indiana Case Studies in Business, pp. 57-78 (No. 2 1954), for a detailed case study of disputes between two family ownership interests which led to widespread conflict, establishment of a competing business, and a court suit. For an example of shareholders' litigation in a family corporation where costs and attorneys' fees were considerably in excess of $100,000, see Perry v. Perry, 160 N.E.2d 97, 106 (Mass. 1959).

a close corporation, choose to purchase securities in public-issue corporations or even permit their accumulated funds to remain idle rather than risk the purchase of a minority interest in a closely held enterprise.

Most small businesses cannot enter national credit markets. The minimum financing which the security markets will handle at the present time is somewhere between $300,000 and $1,000,000. As the sources of equity capital open to large corporations are not available to small businesses, it is all the more important that investment in small businesses be made attractive to local investors and that they be given full assurance that they will receive just treatment at the hands of their fellow participants.

Judging from the amount of recent litigation on squeeze-outs and from remarks of jurists and lawyers, the number of squeeze-outs and attempted squeeze-outs, always considerable, might even be increasing. In commenting on this study, Honorable Collins J. Seitz, Chancellor of the Court of Chancery of the State of Delaware, who has handled at least as many squeeze-out cases as any judge in the country, declared that this project "is of great current interest and importance because I believe it embraces a situation which is becoming more and more common."[6]

§ 1.06 *Objectives of study*

This study will acquaint small businessmen and their legal and business advisers with the fact that dissension and squeeze-outs are of rather common occurrence; that merely because all the participants in a business are members of one family does not assure immunity and may even increase the possibility of a squeeze-play; and that steps can and should be taken at the time of formation of the business to prevent their occurrence.

By enumerating the various squeeze techniques and discussing them in a comprehensive way, this study will enable holders of minority interests in small businesses and their legal advisers to recognize many squeeze-plays in their inception, while there is still time to fight successfully against them. Remedies are available against most squeeze-plays if legal assistance is obtained with sufficient

[6] Letter from Collins J. Seitz, dated Jan. 18, 1960. Unless otherwise indicated, letters cited in this study were addressed to the Project Director.

promptness and the lawyers engaged are resourceful in discovering and utilizing available protective measures and remedies.

The remedies in squeeze-out situations, however, present something of a legal maze. The number of remedies and their effectiveness vary from one squeeze situation to another. Some remedies are conferred by common law; others are statutory. If a squeeze-out is threatened in a corporate enterprise and litigation is brought, it will be found that some actions must be brought in the individual right of the aggrieved shareholder, others in the right of the corporation. In some jurisdictions, this presents difficult legal questions of a technical sort, such as which of the available causes of action a squeezee may join in the same suit.

And the remedies are not wholly legal; proceedings in court and other legal maneuvers may be only a part of a protracted struggle between squeezers and squeezees. After the squeezee discovers or begins to suspect the squeezers' machinations, he probably will first try to get additional information from the corporation and the persons in control. There may follow argument and strife, economic pressures and counter-pressures, threats, perhaps several law suits, and ultimately—this may be years later—a "solution," probably not a clear-cut victory in the courts for either side but more likely a settlement or some sort of negotiated compromise.[7]

As the whole of such a struggle is not reflected in the reported cases, the lawyer cannot find in the law reports all he needs to know about fighting a squeeze-play, even assuming he has the time and skill necessary to dig out the poorly digested and indexed cases on squeeze-outs. The law reports just simply do not tell the whole story. By pointing out the various squeeze techniques that are used and the pressures that are applied and by listing whatever remedies are available for each squeeze-play, the study should enable lawyers to give to clients being unjustly squeezed more effective and less costly service.

The disturbing thought occurs that the cataloguing of squeeze techniques might give ideas to prospective squeezers and thus induce squeeze-plays which would not otherwise occur, or might supply techniques to squeezers searching for ways of eliminating undesired associates. Perhaps in some instances squeeze-outs will be induced or furthered by this study. However, publicity is often an effective

[7] See Rohrlich, Law and Practice in Corporate Control 141 (1933).

remedy for economic diseases. As Mr. Justice Brandeis once commented: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[8] If squeeze techniques are explained in all their ramifications and are made to stand out starkly in the light of common knowledge and understanding, undoubtedly majority interests will be considerably more hesitant to use those techniques unfairly to eliminate minorities or deprive them of their rights without just compensation. And, in any event, this study should help the courts to gain a better insight into squeeze-out problems and perhaps aid them in distinguishing with somewhat more certainty between harsh and oppressive treatment of minorities on the one hand and unfounded minority complaints or necessary elimination of unco-operative and unreasonable minorities on the other.

This study aids the practice of "preventive law" in two significant ways. First, by setting forth and explaining arrangements to protect minority shareholders against squeeze-outs, it enables a lawyer representing persons entering business enterprises to take effective steps when the business is being organized or before trouble develops to guard the interests of his clients. Perhaps more important, by pointing out the underlying causes of squeeze-outs and the typical situations which give rise to them, this study should enable businessmen, lawyers, and other business advisers to remove in advance some of the conflicts of interest, sources of tension, and other possible causes of squeeze-outs, and to set up measures for solving whatever disputes do arise.

These preventive law and planning services, just like services rendered in squeeze-out litigation, can be rendered more effectively and with less cost, it is believed, if the information contained in this study is utilized; this study furnishes a practical guide to squeeze-out avoidance and dispute settlement. Finally, the suggestions in the study for modifications in law and legal controls might help point the way to an improved administration of justice among businessmen even when the businessmen and their advisers have not had the foresight, or for other reasons have failed, to take precautions in advance against dissension, oppression, and squeeze-plays.

[8] Brandeis, Other People's Money, ch. v (1914), quoted in Loss, Securities Regulation 77 (1951).

CHAPTER II. UNDERLYING CAUSES OF SQUEEZE-OUTS

§ 2.01. *Scope of chapter*

This chapter examines the business situations out of which squeeze-plays typically arise, with a view to determining what are the

underlying causes of squeeze-outs. Particular attention is given to the part played in squeeze-outs by the failure of small businessmen to obtain legal advice and the failure of lawyers, when consulted, to foresee squeeze-out problems which might arise and to bring to bear in the solution of those problems timely and effective planning and drafting techniques.

The squeeze-out settings discussed in this chapter probably are not exhaustive. They are based, however, on hundreds of fact patterns drawn from judicial opinions or supplied by lawyers and other business advisers. Undoubtedly they are the most frequently occurring of the situations productive of squeeze-plays.

Some suggestions are made in this chapter for avoiding situations with squeeze-out potential or for resolving disputes which do arise. Only such suggestions are made, however, as can be stated simply and quickly. Elaborate planning suggestions are deferred for treatment in another chapter.[1]

§ 2.02. *Greed and inordinate desire for power or profit*

As might be expected, many squeeze-outs are attributable largely to the avarice of individuals who see and seize opportunities to enlarge their power and influence and increase their wealth or income. Thus, with disappointing frequency, business associates of a person who is in military service or for other reasons is absent from the business for a considerable time take opportunities offered by his absence to eliminate him from the enterprise.[2]

Careful planning and drafting can remove many of the opportunities for squeeze-outs, but undoubtedly clever and unscrupulous men will still on occasion find ways in the financial, administrative, and legal intricacies of business enterprises to take advantage

[1] See Chapter VII.

[2] Funk v. Spalding, 74 Ariz. 219, 246 P.2d 184 (1952); Schwab v. Schwab-Wilson Machinery Corp., Ltd., 13 Cal. App. 2d 1, 55 P.2d 1268 (1936); Brownback v. Nelson, 122 Mont. 525, 206 P.2d 1017 (1949) (partner entered military service); Boxill v. Boxill 111 N.Y.S.2d 33 (Sup. Ct. 1952) (partner, a singer, left country on concert tour and turned over management of boarding house to co-partner brother, who proceeded to purchase in his own name the building occupied by the business); Dillard v. Wholesale, 286 S.W.2d 675, 676 (Tex. Civ. App. 1956) ("In April 1954 Koukas took a trip out of the state and while he was gone Dillard sent him a telegram that he need not hurry back as he, Dillard, was closing the store. Koukas came home on receiving the telegram and went to the store. Dillard told Koukas to hand over his key as he was kicking him out.") See also Alexander v. Sims, 220 Ark. 643, 249 S.W.2d 832 (1952).

of trusting or less able associates. Irrespective of what laws are enacted or what precautions are taken in the initial planning stages of business enterprises, squeeze-outs probably can never be eliminated completely.

Nevertheless, squeeze-outs result far less often from sheer grabs for power or profits than might be supposed. The majority of squeeze-out cases are characterized by basic conflicts of interest among the participants in the enterprise, protracted policy disagreements or other dissension prior to the squeeze-play,[3] or demonstrated inability of one or more of the participants (because of habitual drinking or lack of business skills, for example) to carry a fair share of the responsibility and work involved in operating the business.

§ 2.03. *The inactive shareholder*

Whenever all the shareholders in an enterprise are actively working full time to build its business, dissension is relatively rare. Often trouble develops only after one of the original participants becomes inactive or his interest is acquired by an inactive shareholder.

A shareholder or partner of course may withdraw from active participation in the business for many reasons. He may make a felicitous marriage and no longer be willing to take an active part in the business; he may reach retirement age; he may become insane; he may sell his interest; or he may die, passing the stock to his widow or heirs.

There is a great deal of room for friction between active and inactive participants. Differences are especially likely to occur on the respective amounts to allocate to salaries and dividends. Whenever all shareholders of a closely held corporation devote full time to its affairs, they ordinarily take a substantial part of the earnings of the corporation in salaries rather than in dividends to minimize "double taxation." This practice, however, is obviously not satisfactory to a shareholder who is not on the payroll.

An incapacitated shareholder or the widow of a deceased shareholder may well expect to receive the same return from the corporation that the shareholder received when he was active. The persons

[3] See Cottrell v. Pawcatuck Co., 128 A.2d 226 (Del. 1957) (corporate minutes reflected over the years numerous objections and criticisms voiced by plaintiff of the actions of the majority).

still active in the business, however, in all probability will not be willing to place or keep on the payroll a shareholder who is not working. They may even be opposed to paying substantial dividends to a shareholder not actively contributing to the corporation's success. The active participants, having been forced to take on additional duties, not unnaturally may feel that the returns of the business are largely due to their efforts. Therefore, they raise their own salaries, decrease or stop dividends, and perhaps take other steps to squeeze out the widow or the inactive shareholder. Thus conflicts between the interests of active and inactive shareholders may well lead to bitter disputes and expensive litigation.[4]

§ 2.04. *The decease of founder or other key shareholder*

The section immediately preceding points out how the death of an active shareholder quite often brings an inactive shareholder into the business and sets the stage for dissension and possible squeeze-out, because there is a very sharp conflict of interest between active and inactive shareholders. The death of one of the founders or of a principal active shareholder also often brings into play other circumstances which will lead to a squeeze-out. For one thing, even if the successor shareholder wants to participate actively in the business and has business training and experience, the personalities of the survivors and the successor may be such that they simply cannot work together in harmony. A situation of this kind occurred in a leading New York case. It was described by the dissenting judge in the following language:

> For upwards of thirty years, petitioner Radom and Henry Neidorff, respondent's husband, shared equally in the ownership and management

[4] See, e.g., Application of Burkin, 1 N.Y.2d 570, 136 N.E.2d 862 (1956). In Godley v. Crandall & Godley Co., 212 N.Y. 121, 105 N.E. 818, 819, 632 (1914), the court referred to the case there being considered as "the typical case of a dispute arising from the incorporation of a trading partnership followed by the death or incapacity of one of the members and the adoption by the others of measures to limit the dividends of the inactive shareholder to what they conceive he ought to have." In Connelly v. Weisfeld, 142 N.J. Eq. 406, 59 A.2d 869 (1948), the surviving shareholder put the widow of the deceased shareholder on the corporation's payroll at an amount ($100 a week) equal to the allowance she had received from her husband. "She took the money for a month then, at a directors' meeting to which Henry [the surviving shareholder] had invited her, she protested a suggested reduction to $60 per week. Her attitude and words offended Henry and he discontinued her allowance." *Id.* at 408, 59 A.2d at 871.

of Radom & Neidorff, Inc. Through all that time, their relationship was harmonious as well as profitable. Neidorff died in 1950, at which time respondent, through inheritance, acquired her present 50% stock interest in the business. Since then, all has been discord and conflict. The parties, brother and sister, are at complete loggerheads; they have been unable to elect a board of directors; dividends have neither been declared nor distributed, although the corporation has earned profits; debts of the corporation have gone unpaid, although the corporation is solvent; petitioner, who since Neidorff's death has been the sole manager of the business, has not received a penny of his salary—amounting to $25,000 a year—because respondent has refused to sign any corporate check to his order. More, petitioner's business judgment and integrity, never before questioned, have been directly attacked in the stockholder's derivative suit, instituted by respondent, charging that he has falsified the corporation's records, converted its assets and otherwise enriched himself at its expense.[5]

Furthermore, whenever a shareholder dies, his block of shares may be broken up and distributed among a number of persons and thus create several minority interests and enhance the chance of some incompatible shareholders being introduced into the company.

Often, too, surviving shareholders, because of the inexperience of the deceased's widow and her assumed incompetence to participate actively in the business or to protect her interests, seize complete control of the business and refuse to give the widow any voice in corporate affairs. This is sometimes done even though the widow holds or controls half the voting shares. In a leading Connecticut case,[6] for example, the surviving shareholder in what had been essentially a two-man company seized control of the corporation after the death of his associate and "conducted the corporation as though he personally owned all the outstanding stock."[7] He did not consult the widow, either in her capacity as shareholder or as director.

§ 2.05. *The problem of the aged founder who "hangs on"*

Not uncommonly the founder of an enterprise, accustomed to running it as a "one-man show," regards the company and its assets

[5] *In re* Radom & Neidorff, Inc., 307 N.Y. 1, 9-10, 119 N.E.2d 563, 566-67 (1954) (Fuld, J., dissenting).

[6] Krall v. Krall, 141 Conn. 325, 106 A.2d 165 (1954).

[7] *Id.* at 329, 106 A.2d at 167.

as his own absolute property. He often becomes more tyrannical with increased age. He may insist on retaining complete control long after he should retire, following superannuated methods and practices, ignoring wishes of his co-directors and advice of associates, and disregarding corporate procedures. An oldster may dominate the business even after he has become senile and mentally infirm and has begun to indulge in various eccentric acts and to make absurd management and policy decisions.[8] For instance, one sick old gentleman moved his own office at great expense to a distant metropolis and without visiting the principal establishment of the company, made all decisions both large and small by long distance telephone.

Sometimes an aged founder creates dissension by continuing to draw compensation after he has ceased to render useful services to the corporation. For example, minority shareholders of a Colorado corporation naturally were displeased when the majority shareholder continued until his death to draw full salary as the company's President and General Manager, even though during the last five years of his life he was physically unable to do very much work for the company and during a part of the period lived in California, where the corporation did not do any business.[9]

The age of a participant who retains control of an enterprise after his mental facilities have begun to fail may contribute to squeeze-outs in another way. His weakness and gullibility may be seized upon by an associate and utilized to squeeze out a third participant.[10]

A leading English case, *Re H. R. Harmer, Ltd.,*[11] decided by the Court of Appeal, illustrates the aged founder problem. In that case two shareholders brought suit asking for relief from the high-handed and oppressive conduct of their eighty-eight-year-old father. The father had founded a stamp business and had operated it

[8] See Tansey v. Oil Producing Royalties, Inc., 133 A.2d 141, 147 (Del. Ch. 1957), where the court referred among other things to defendant's advanced age and "strange" ideas concerning proper corporate management in deciding that "the strong evidence necessary for the appointment of a receiver for a solvent corporation exists here in ample measure." In this same case, the court noted that since "about 1932, the officers and directors were in effect largely ignored by the defendant and the requirements of the corporate form were more honored in the breach than in the observance." *Id.* at 146.

[9] See Calder, Cases in the Management of Small, Family-Controlled Manufacturing Businesses, Case 3, in Indiana Case Studies in Business 56, 62 (No. 2 1954).

[10] See, e.g., *In re Faehndrich's petition,* 151 N.Y.S.2d 261 (Sup. Ct.), aff'd mem., 152 N.Y.S.2d 413 (App. Div. 1956).

[11] [1958] 3 All E.R. 689 (C.A.).

successfully for many years. Eventually he incorporated it, giving to his two sons most of the nonvoting shares, which carried the major beneficial interest in the company, i.e., liquidation rights and rights to divisible profits, but retaining for himself and his wife most of the voting shares, which carried no right to participate in profits. The father and the two sons were all life directors of the company; in addition, the company's articles designated the father governing director but did not define the powers of the governing director or reduce the powers of the other directors.

The father, perhaps believing that his voting control entitled him to run the business just as he had before incorporation, assumed powers he did not have, disregarded resolutions of the board of directors, and in general interfered autocratically in the company's day-to-day affairs. Among other things, he opened a branch in Australia without authority, procured the appointment of directors whom he expected to vote as he directed, dismissed employees summarily, and told a prospective employee that one of the sons was "wrong in the head" and would not be with the company much longer.

The suit was brought under Section 210 of the English Companies Act of 1948, which gives broad powers to an English court to protect minority shareholders against oppressive conduct. The petitioners asked for the following relief: (1) a change in the company's regulations to confer voting rights on the nonvoting shares; or (2) an order requiring the father to sell his shares or at least his voting shares to petitioners; and (3) removal of the father from his office as director and alteration of the company's articles of association accordingly, on the company's undertaking to pay to the father and his wife such pension as the court might think proper; or (4) whatever order would be just.

The court held that the petitioners had proved their case and entered an order under Section 210, but (with the agreement of the petitioners) not in the terms of the prayer in the petition. On appeal, the Court of Appeal held that relief under Section 210 had been properly granted. The affairs of the company had been conducted in a manner oppressive to the petitioners as members, not merely as directors. Even if the father's acts might lawfully have been done pursuant to formal authority from a general meeting, the petitioners were entitled to insist that proper procedure be fol-

lowed. The fact that the sons had originally acquired the shares as a gift from the father (if that were a fact) was irrelevant. Further, even if the sons at the time they acquired their shares contemplated that the father would retain control, it could not be assumed that they knew the father would exercise that control irregularly and without giving any effect to their own life directorships. Finally, if the father had gotten no pecuniary benefit from what he did, his conduct would still have been oppressive: "If there is oppression, it remains oppression even though the oppression is due simply to the controlling shareholder's overweening desire for power and control and not with a view to his own pecuniary advantage."[12]

The problem involved in this case probably would have presented even greater difficulties in this country because our courts do not have the broad powers and flexible remedies provided by Section 210.

Perhaps clear-cut retirement, disability and deferred compensation arrangements, carefully worked out while the founder is in his prime, would go far to eliminate the aged-founder problem. Then, upon the arrival of the predetermined retirement date, the founder might be psychologically prepared to step down gracefully and yield position and power to a younger man. At the same time, whatever pension or deferred compensation the oldster would thereafter receive, having been determined in advance, could hardly furnish a basis for complaint by other shareholders.

§ 2.06. *Drive of superior talent to rise*

Even where all the shareholders actively participate in the management and operation of the business, dissension and eventually an attempt at squeeze-out may develop if some of the participants are obviously more competent than others.[13] A lawyer who represented the squeezee in a typical case of this kind described the situation there with refreshing candor in the following colorful language: "Our client, ———, was lazy and dumb. The defendant, ———, was energetic and sharp. There was no fraud involved."[14]

[12] Jenkins, L.J., [1958] 3 All E.R. at 704.

[13] Letter from Arthur L. Berger, dated Oct. 2, 1959.

[14] Citation for this statement is withheld to preserve anonymity of the lawyer and parties involved.

The more able people often feel that the others are holding back the growth of the enterprise or are getting an unduly large portion of the returns of the business. Perhaps in the beginning the money, assets, or business contacts of the less able participants were needed to launch the business; but when the success of the enterprise has been assured, the more able may decide to eliminate what by then seems to them to be a parasitic group. At the same time, the less competent often develop great jealousy for the obvious talents of the gifted.[15]

In the long run, the capable tend to gain the upper hand, even assuming that all parties involved have high ethical standards. This is true even in a family corporation; the dominant businessman in the family often eventually pushes out the less able members of the family, diminishes their participation, or excludes them from new opportunities which arise out of the enterprise.[16]

Usually the more able and aggressive participants do not have to resort to a full-fledged squeeze-play to eliminate their undesired associates. The pressure is somewhat more subtle and gentle. They gradually take over a greater and greater part of management responsibilities until the other group sees the handwriting on the wall and sells out. The competent participants may simply state that they consider continuation of the business on the existing basis to be untenable and suggest that one group should buy out the other; this generally results in the gifted participants being the purchasers, because they can usually obtain financing more easily and they have the confidence to proceed.[17] Sometimes, however, the less capable participants hang on bitterly, refusing to sell or to relinquish control until drastic squeeze tactics are applied; and on occasion, they manage to turn the tables and eliminate their more gifted brethren.

Solutions of the problems of the enterprise with participants who differ markedly in abilities defy generalized statement. In the first place, the business skills and mental powers of the individuals involved differ infinitely in kind and quality; thus each problem situation is unique. Secondly, proper reward for business talent often seems to be in conflict with fair treatment of those who are less able but who have contributed their resources to an enterprise, have

[15] Letter from William T. McNeill, dated Oct. 7, 1959.
[16] See, e.g., Black v. Parker Mfg. Co., 329 Mass. 105, 106 N.E.2d 544 (1952).
[17] Letter from Arthur L. Berger, dated Oct. 2, 1959.

sacrificed for it, and have built up high expectations of eventually sharing in the growth of the business. Furthermore, the welfare of the enterprise and justice to the individuals involved may point in different directions.

Perhaps this is an area where law and legal controls cannot always play an effective role. Protective devices, such as carefully prepared buy-out arrangements, set up in advance, which state the terms under which one group or the other will sell its interest in the event of prolonged dissension, can be helpful; but they can go only so far to protect the less able against what appears to be a hard fact of business life: those with superior business talents will usually demand and receive the lion's share of the rewards of a successful enterprise. In the marginal areas of conduct perhaps there is no substitute for the consciences of the individuals involved. Yet, in court or out, squeezers can almost invariably justify their action, apparently with sincerity, even in fact situations where researchers trying to be objective conclude that the explanations given for the squeeze are mere rationalizations rather than true justifications. Thus reliance on the individuals' sense of right and wrong seems hardly an adequate answer.

§ 2.07. *The autocratic controlling shareholder; acquiescence by some shareholders in assumption of special privileges by others*

In many instances a shareholder who also holds a directorship and the chief executive position in a corporation runs the business in a one-man, autocratic manner that is not appropriate in an incorporated enterprise, at least if there are other shareholders. He disregards the views of his co-directors, and in fact completely ignores customary corporate procedures and paraphernalia. Such high-handed practices of course ultimately lead to conflicts with other strong personalities among the shareholders[18] and set the stage for a squeeze-play.

Sometimes the other shareholders acquiesce in the use of some of the corporate assets by one of their number for his personal benefit, perhaps over a period of years while the corporation has no

[18] See, e.g., Nash v. Lancegaye Safety Glass (Ireland), Ltd., 92 Ir. L.T.R. 11 (H.C. 1958).

particular need for the asset; conflict develops when the corporation needs the assets. For example, in one case that was settled before decision in court, one of the shareholders in a two-man company occupied vacant real property of the corporation, paying a rent which was a great deal less than the property's fair rental value. The other shareholder acquiesced in this, believing that eventually the occupant would pay a suitable rental or that the corporation would develop the property or sell it. As the years passed, it became increasingly clear that the occupant intended to retain his advantage; he resisted any attempt to sell the property or improve it or to increase the rental. The relationships of the parties deteriorated to such an extent that each was anxious to eliminate the other.

§ 2.08. *Disregard of corporate ritual and failure to keep proper records*

Failure to observe the formalities of corporate operation and neglect of paper work often lead to dissension which eventuates in a squeeze-out. In many small business corporations—and this is especially true in family corporations and in businesses which were originally conducted in the partnership form—meetings of shareholders and directors are not held and traditional corporate ritual is disregarded.[19] By-law requirements are quite commonly flaunted; and indeed, in some parts of the country, many small business corporations do not have by-laws or even minute books. There may be a fragmentary file of corporation minutes, but that file will often be limited to copies of a few resolutions required by the exigencies of business, such as resolutions required by banks for the opening of checking accounts and resolutions required for the passage of title to real property.

If the affairs of a corporation are conducted informally and paper work is neglected, the stage is set for serious trouble when-

[19] See, e.g., Roles v. Roles Shingle Co., 147 Ore. 365, 31 P.2d 180, (1934); First Nat. Bank of Burns v. Frazier, 143 Ore. 662, 22 P.2d 325 (1933); Mickshaw v. Coca Cola Bottling Co. Inc. of Sharon, Pennsylvania, 166 Pa. Super. 148, 70 A.2d 467, (1950). The business involved in Funk v. Spalding, 74 Ariz. 219, 246 P.2d 184 (1952), was operated from 1935 to 1937 as a two-man partnership. In 1937 the business was incorporated, each of the former partners receiving half the stock. However, the parties continued to operate the business much as before. Shareholders' and directors' meetings were not held; corporation reports were not filed. In 1948 the Corporation Commissioner revoked the company's charter for failure to comply with the report-filing law.

ever any difference arises among the shareholders. There may be no way of establishing, unequivocally, exactly what action has been taken in the past on the matter in question, when action was taken, and by whom; this is especially true after the death of persons who supposedly participated in the matter. Naturally suspicions are aroused, and each side "plugs" for its own particular view of the facts. Furthermore, the fact that records do not exist enables the unscrupulous to manufacture evidence and to push with some chance of success claims which they know are unjustified.

To guard against dissension and squeeze-outs, the participants in an incorporated business, no matter how small it may be, should adopt by-laws to govern its internal affairs, should hold separate meetings of shareholders and directors, should record minutes of those meetings, should maintain bank accounts for the corporation separate from those of its various shareholders, and should keep its assets separate and apart from those of its shareholders.

§ 2.09. *View that corporation belongs to shareholder-employees*

In some companies controlling shareholders and company management feel that the company belongs to those shareholders who work for it.[20] Stock ownership is viewed as giving the stockholder a preferred status as an employee and not as entitling him to a return on an investment by way of dividends. Thus in one case the controlling shareholder and manager of a corporation indicated that if his sister should inherit an equity in the business, the other shareholders would expect her husband to become actively engaged in the business.[21] Whenever controlling shareholders hold views of this sort, naturally they tend to disregard the rights of those who originally invested in the company or later acquired ownership in it but who do not choose to work for it. To get a return from their investment shareholders must become and remain employees, though that may be quite disagreeable to them, or they must risk costly and uncertain legal action.

[20] See Calder, Cases in the Management of Small, Family-Controlled Manufacturing Businesses, Case 3, in Indiana Case Studies in Business 57, 67 (No. 2 1954).
[21] *Ibid.*

§ 2.10. *Viewing incorporated enterprise as a "partnership" or "family business"*

Many shareholders in small, incorporated businesses apparently do not understand fully the consequences which flow from incorporation, and in particular they do not realize that in the absence of special arrangement, ultimate and near-absolute control in a corporation lies in the hands of the holders of a majority of the voting shares. The participants in a small business usually think of themselves as partners and they often refer to each other as such. In many instances, the business was in fact conducted originally, perhaps for years, in the partnership form. The only reason for incorporation might have been to obtain limited liability or some tax advantage. After incorporation, the participants assume continuation of partnership relations and partnership rules.

The law, however, generally applies to their relationship the rules applicable to shareholders, not those applicable to partners. A Massachusetts case[22] illustrates this. The business of the plaintiff and his two associates was organized in the form of two corporations. The plaintiff contended that he and his associates were partners. The court rejected this argument in the following language: "The chief basis for contention that there was a partnership seems to be that the parties frequently referred to themselves as such. . . . The relationship, whatever it was, took form within the framework of two existing corporations, which continued to be legal entities distinct from their stockholders. That the plaintiff, the defendant, and Clark were the principal stockholders did not make them partners or either corporation a partnership. . . . It is not enough that the parties referred to each other as partners."[23]

This tendency of shareholders in a small incorporated enterprise to regard themselves as partners quite often leads to strife. In the first place, minority participants, thinking of themselves as partners, are surprised and hurt when majority shareholders, exercising the power they have under the principle of majority rule, assume complete control of the enterprise and ignore the views and wishes of the minority. Secondly, the failure to follow corporate procedures

[22] Martin v. Stone, 332 Mass. 540, 126 N.E.2d 196 (1955).
[23] *Id.* at 546, 126 N.E.2d at 200.

leaves many corporate transactions and decisions with shaky legal foundation and encourages disputes and litigation. Among the corporate procedures disregarded may be some established by statute for the protection of minority shareholders.

In many small businesses the shareholders and other members of their family, or some of them at least, think of the business as belonging to the family as a whole rather than to the shareholders. Sometimes all of the shareholders are descendants of the original founder, and the founder may have directed by will or otherwise that the business be used for the continued support of the family.[24] This leads to the use of corporate assets by members of the family, loans to members of the family without interest, intermingling of corporate and individual money and assets, payment of compensation to officers without formal board authorization, and in general an ignoring of the separate entity of the corporation and failure to observe the formalities of corporate action. Again, this lax handling of the enterprise's affairs sets the stage for dissension.

§ 2.11. *The problem of the unreasonable and uncooperative minority shareholder*

Time and again, when questioned about squeeze-out problems, lawyers and other business advisers comment on the problem of the minority shareholder who "throws his weight around" and makes life miserable for management.[25] An unreasonable and obstreperous shareholder may voice frequent objections and criticisms of management, harass employees, demand information on corporate affairs at unreasonable times, bring shareholder's derivative actions, and in general give company managers a "rough time."[26] Some corporate

[24] See, e.g., Fortugno v. Hudson Manure Co., 51 N.J. Super. 482, 144 A.2d 207 (1958). In Connelly v. Weisfeld, 142 N.J.Eq. 406, 407, 59 A.2d 869, 871 (1948), the court commented that the business there involved was conducted as a family corporation and in an informal manner and that "withdrawals of money for compensation of officers were informally made, loans were made to members of the Weisfeld family and no interest charged, automobiles were furnished for the free use of the officers, and complete books of account were not kept."

[25] Letter from David Hardy, Oakland, Calif., dated Sept. 28, 1959; letter from Henry M. Johnson, Jr., C.L.U., Northwestern Mutual Life Insurance Co. of Milwaukee, dated Aug. 27, 1959; letter from Clinton R. Stevenson, Los Angeles, Calif., dated Oct. 26, 1959.

[26] See, e.g., Cottrell v. Pawcatuck Co., 128 A.2d 225 (Del. 1956), appeal dismissed 355 U.S. 12 (1957).

officers say they have to spend more time and thought in keeping a minority shareholder pacified than in operating the business.

Illustrative is a Massachusetts case,[27] where a minority shareholder in a family corporation sought employment by the company and was given a job; but, after he twice used a company automobile for personal purposes contrary to orders and otherwise proved unsatisfactory on the job, the company discharged him. Therefore, he brought suit charging that management had paid excessive salaries, made improper loans, and engaged in various other improprieties. The judge found that " 'the greater portion of this litigation was without proper foundation and justification.' "[28]

Quite often a minority shareholder appears to be trying to force a buy-out at an exorbitant price or some other concession as a condition to corporate peace.[29] Naturally, majority shareholders and corporate management welcome an opportunity to eliminate an unruly or unco-operative associate from the enterprise.

§ 2.12. *Acquisition of competing business by minority shareholders*

Action of minority shareholders in establishing or purchasing a business which competes with the corporation sometimes triggers a squeeze-play. The following situation is illustrative.[30] The Carlson family had been minority shareholders of Thompson Corporation since 1906, owning a 30 per cent interest in the business. The Brown family had owned the controlling interest since 1910. The action of the Carlson family in purchasing a competitive company in 1951 brought to a head a controversy which had lasted for over forty years regarding control of the business.

The original Carlson and the original Brown were both dead and the dissension was between the children of these two. The Carlson brothers were older and much more experienced in the business than the Browns, and they heartily resented the fact that the Brown brothers had taken over active management of the

[27] Perry v. Perry, 160 N.E.2d 97 (Mass. 1959).
[28] *Id.* at 106.
[29] See Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952).
[30] Taken from Calder, Cases in the Management of Small, Family-Controlled Manufacturing Businesses, Case 3, in Indiana Case Studies in Business 57 (No. 2 1954).

business. When it became apparent that the Carlsons could never manage the company, they first offered to buy-out the Browns and then offered to sell-out to them; both offers were rejected.

Therefore the Carlsons, having a little spare capital, bought a competing manufacturing business, after notifying the directors of Thompson Corporation that they intended to do so and offering the Browns a minority interest in the new business with substantially the same status as the Carlsons then occupied in Thompson Corporation. This offer also was rejected.

Then came the squeeze-play. The Carlsons were dismissed as employees and removed from the board of directors, and a newly constituted board issued to the shareholders stock rights to purchase one additional share for each share held. The Carlsons, having all their capital tied up in the new company, were unable to exercise their pre-emptive rights, with the result that their stock holdings in Thompson were diluted by 50 per cent.[31]

Not infrequently the tension and strife brought about by dissension causes shareholder-employees to withdraw from their employment with a corporation. As they have usually developed special skill in the particular business, it is only natural for them to seek employment with a company in the same or a similar line of business. Thus, whether as employees only or as owner-employees, they go into competition with the old company. The shareholders in control of the old company often feel that shareholders who have an interest in a competitor pose an unusual competitive threat, because shareholders generally have a right to examine the company's books and records and therefore have access to information not normally available to competitors. Thus the stage is set for a squeeze-play.

§ 2.13. *Failure to provide properly for new inventions by inventor-shareholder*

Many times business enterprises are organized to exploit a new invention or a patent. The usual story is that an inventor without sufficient funds to "cash in" on his discovery gets together with several affluent individuals who have funds to launch an enterprise.

[31] See also Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951), where the competing business situation was compounded by the failure to provide properly for new inventions by inventor-participant, discussed, *infra*, § 2.13.

The group then organizes a corporation to exploit the invention or patent. Not uncommonly the "money men" get the lion's share of the stock for financing the company, but a substantial block of shares goes to the inventor in consideration of his transferring his patents to the corporation.

In many instances dissension eventually develops between the inventor and the other participants because no provision has been made for the possibility—indeed, in many instances, the probability —that the inventor will continue to work on the machine he has invented or the process he has evolved, will improve his original invention, or perhaps even make a new discovery which will render the old invention obsolete and the patents based on it valueless.[32]

If the business prospers, and especially if the inventor has business talents and is managing the enterprise, the inventor is likely to feel that the success of the enterprise is due largely to his ingenuity and efforts. Naturally he is inclined to press for a larger share in the rewards of the enterprise. He may demand payments from the

[32] See, e.g., Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951); Crichton v. Webb Press Co., 113 La. 167, 36 So. 926 (1904). In the *Crichton* case, the inventor and his brother received well over half the shares in the corporation and expressly reserved "all inventions or discoveries to themselves, same as if not employed by the Company." Yet the inventor's improvements of the compress on which the company depended and his eventual development of a new compress, which was to drive the compress based on his original invention off the market, raised questions which the parties had not contemplated, much less answered by prearrangement. The following comments of the court are instructive:

"Out of these inventions, or as a result of them, have grown, in the main, the differences between the parties, who have been unable to agree what amount, if any, the Webbs should charge the corporation for the use of their inventions.

"Some of the improvements were put on in the very first year of the company's business. . . . Others were added as made. The Crichtons would not admit that the use of these improvements was beneficial to the company, nor that the charges made for them by the Webbs were reasonable; but the Webbs had the business of the company in hand, and went on using the improvements, and the questions of the right to use them and of the proper amount to charge for their use remained open.

". . . .The invention of this new press brought an unforeseen complication in the business of the company. The Crichtons were part owners of the 90-inch patent [the old compress], for the lease of which the company was under contract to pay $5,000 per press, and they owned no interest in the new invention; and naturally the Webbs, owners of the new invention, wanted to be paid for the use of it. . . .They demanded the same rental which the company was under contract to pay for the use of the 90-inch patent. The Crichtons insisted that the 90-inch patent was a good press, which had practically driven all competitors from the field, and that the company should go on using it. They objected to the use of the 80-inch invention, and especially objected to paying so large a rental. The Webbs, on their side, insisted that the 80-inch press was a better press in every way, stronger, safer, and cheaper, and that if it was not adopted by the company they would have to dispose of it to others, and that it would easily drive the 90-inch press out of the market; and we may mention here that the testimony leaves no doubt that such was the fact. Also, we may say here . . . that their right to exact payment for the use of their invention cannot be doubted." *Id.* at 174, 36 So. at 928-929.

corporation for improvements he has made in a machine, or he may threaten to sell a new invention to a competitor of the corporation. Eventually he may try to wrest the enterprise away from his associates or they may attempt to eliminate him.

Hyman v. *Velsicol Corporation*[33] is illustrative. In that case, Velsicol Corporation was organized to exploit an invention of plaintiff, a research chemist. Each of the two corporate defendants contributed $8,000 to the new corporation, and each received eighty shares of stock in it; plaintiff assigned to the company two applications for patents on the invention and received forty shares of stock. Later the two corporate defendants loaned Velsicol $264,000 for building and operating purposes. Sales of the new company increased tremendously, and plaintiff, who had acted as its managing vice-president from its inception, sought a greater proportion of the stock interest. He refused to assign certain applications for patents covering insecticides known as "1068" to Velsicol until his interest in that company was increased. A dispute ensued and plaintiff resigned as vice-president. Velsicol then brought suit to compel plaintiff to assign the applications for patents. Soon thereafter plaintiff brought about the organization of another corporation to manufacture and sell "1068." In the meantime, Velsicol won its suit to compel assignment of the applications for patents. A month or so later the majority shareholders of Velsicol began to apply a squeeze by reorganizing the corporation and issuing a large number of shares, which had the effect of reducing plaintiff's proportionate interest in the company.

Firm arrangements made at the organizational stage, providing for future inventions to be turned over to the corporation and specifying terms of payment, might prevent many disputes from developing; and the practice of many experienced lawyers is to include in the promoters' contract or other pre-incorporation agreement a clause covering future inventions. Yet a doubt might well abide whether an inflexible arrangement, entered into at a time when the inventor is in an extremely weak bargaining position, is really a satisfactory solution, because it prevents pragmatic adjustments from time to time to bring the rewards of the various participants more nearly in line with the real worth of their respective contributions to the enterprise.

[33] 342 Ill. App. 489, 97 N.E.2d 122 (1951).

§ 2.14. *Issuance of small number of shares as qualifying shares or as incentive to employees*

In jurisdictions requiring directors to be shareholders, not infrequently a share of stock is issued to a person in order to qualify him for election to the board. In a surprising number of these cases no provision is made for the return of the stock after he ceases to be a director, and he is allowed to retain it. The years pass and, as profits are plowed back into the business, the share increases many times in book value.

In time the shareholder demands dividends or some return on what he now considers valuable property. The other shareholders naturally feel that he is not entitled to share in the profits of the business because he has paid nothing for his share. They do not view him as an owner or "partner." If he causes trouble, the other shareholders probably will take whatever steps they can to eliminate him from the business. Whether rightly or wrongly, he may feel at this point that he is being squeezed.

Not uncommonly controlling shareholders even in a small corporation issue a few shares to employees under some incentive arrangement or pursuant to some scheme to stimulate loyalty to the enterprise and reduce the risk of labor troubles. Programs of this sort of course are often very advantageous to a business, but they sometimes result ultimately in disillusionment and bitterness on the part of the employees, because the employees eventually realize that they are not really being treated as owners of the business and that dividends, if any, are small and far between.

The issuance of a few shares to a person with the thought that he will be a sort of nominal shareholder and not exercise in any substantial way the rights of a shareholder is dangerous, not only because he does have inspection rights and the other rights of a shareholder and may decide to use them, but because in a surprising number of cases he will at one time or another find himself holding the balance of power between opposing groups of shareholders. Furthermore, quite often a disgruntled holder of a few shares succeeds in stirring up trouble among the other shareholders.

A Midwestern lawyer outlined the following case.[34] A and B were the sole shareholders of the corporation, A holding 150 shares and B holding 125 shares. B wanted to sell his shares to C, but C would not buy because the shares constituted a minority interest. Without obtaining assistance from an attorney, the parties agreed that C would buy B's shares and that the corporation would issue C an additional 25 shares at the same price per share he was paying B. After the issuance of the additional shares, C held one-half the outstanding shares and he became a member of the board of directors; but he was still dissatisfied, because A was President of the corporation and a member of the board and the third member of the board was a friend of A. Someone suggested that both A and C had confidence in B and that if B could be placed in a position to act as an arbiter the fears of C could be allayed. Therefore, the corporation issued five shares each to A and C without consideration, and they in turn transferred those shares to B. The result of this arrangement was that A and C each owned 150 shares of stock and B held 10 shares; and the membership of the board was composed of A, B and C. Over the years the book value of the corporation's stock increased tremendously—from $25,000 to $750,000. On the whole the affairs of the corporation ran smoothly, but A became very jealous of C's obviously superior business abilities. During this time B was not called upon to render any services to the corporation, but he did become aware of the increase in the book value of the stock and decided that dividends should be paid on his ten shares. He did all he could to create serious dissension between A and C, and eventually he succeeded. At that point, B offered his shares to A, and A bought them at twice their book value. At the next annual shareholders' meeting, A took control of the board and soon thereafter caused C to be discharged from his employment by the corporation. Although the business continued to show a profit, A then was in a position to withhold dividends in an effort to force C to sell out to A at a low figure. As a result of this squeeze, C was cut off summarily from an income which for the previous seven or eight years had averaged more than $75,000 a year.

Among other things, this case illustrates the dangers involved

[34] Citation of authority is omitted to preserve the anonymity of the attorney and the parties involved.

in entering into shareholders' agreements or other control arrangements without obtaining top-flight legal assistance. Ideally each party should be represented by separate counsel. In this case C's interest could have been protected by proper legal arrangements at the time he bought into the enterprise.

§ 2.15. *Inability of minority shareholder in close corporation to dispose of his interest*

The inability of holders of minority interests in small corporations to dispose of their interest without serious financial loss undoubtedly prolongs dissension in many instances and encourages squeeze-plays. In a large public-issue corporation, a shareholder who is dissatisfied with the way the business is being operated can sell his stock at no great financial loss. That "way out" is not available to a shareholder in a close corporation. Anything less than a controlling interest in a close corporation does not have a ready market; and, if there is dissension in the corporation, a minority interest is likely to appear even less inviting to a prospective purchaser. Further, if there are restrictions on the transferability of shares, as is now often the case, an obstinate associate may be in a position to discourage sale of the shares even if a willing purchaser is found. A minority interest in a close corporation usually cannot even be pledged to obtain funds, because banks and other financial institutions will not accept it as collateral.

Often the only prospective buyers of a minority interest in a small corporation are the majority shareholders.[35] Thus the temptation is great for the majority shareholders to apply a squeeze. The minority shareholder cannot sell out and turn the fight over to persons with greater business knowledge or stronger financial resources.

How the inability of minority shareholders to dispose of their interest without serious financial loss, coupled with other considerations, can lead ultimately to a squeeze-play is illustrated by

[35] The situation which confronted a testamentary trust attempting to dispose of the interest of a deceased shareholder in a close corporation is described in Connelly v. Weisfeld, 142 N.J. Eq. 406, 408, 59 A.2d 869, 871 (1948), as follows: "Disposal of the stock posed a serious problem. There was no public market and Henry was the only person who could be expected to buy, as he alone knew the business and, with his sister, held corporate control."

the following graphic description of the gradual deterioration of relations between majority and minority shareholders in a small corporation engaged in the manufacture and sale of metal and rubber stamping equipment:

> Mr. Brown, Sr., may himself have thought that he was giving the Carlson family, as minority stockholders, the same rights that he enjoyed as a majority stockholder, but he did not recognize that the right of choice could not be exercised by them. They were obligated to accept the decisions which he made for them. He had decided that he and his sons would all be active in the business as owner-workers, that the profits of the business would be dispersed in the form of salaries or retained in the business rather than paid out in the form of dividends. The Carlsons were required to accept these decisions. Their inability to sell their stock when or if they chose, their inability to use the stock to provide adequate security for their dependents in the form of dividends, their inability to determine policies and exercise their initiative in the general supervision of the business—all these things caused them to be resentful and to seek control of the business. When they found that they could not gain control, they decided to establish a company of their own where they could have freedom of action.
>
> Once the Carlsons had acquired another business, the Browns contended that their equity in the A.B. Thompson Corporation had been forfeited, though the book value of the stock had increased five times since the company was founded, and the Carlsons had made a real contribution in the form of reinvested earnings, overtime, and the exercise of those ownership qualities which are very often most important in building up a small business. The Browns' relations with their former business partners then became an entirely changed situation. Resentment and conflict now became evident. This attitude, in a way, is understandable because, since the new Carlson business was believed to be underfinanced, each dollar which was paid out to the Carlsons would build up their business and make competition that much more severe. This attitude may have prompted many of the subsequent decisions of the Browns in causing the Carlsons to "wither on the vine," and in causing their equity in the A.B. Thompson Corporation to become progressively less valuable.[36]

§ 2.16. *Difficulty of valuing a business interest*

The difficulty of determining the value of an interest in a small business is sometimes, it is believed, the really underlying cause of

[36] Calder, Cases in the Management of Small, Family-Controlled Manufacturing Businesses, Case 3, in Indiana Case Studies in Business 57, 68-69 (No. 2 1954).

a squeeze-out. Disagreement among the participants over the value of an interest appears to be a kind of prelude, a starting point of dissension from which gradually unfolds the ugly drama of a full-fledged squeeze-play. However, the nature of this underlying cause of squeeze-outs, the way in which it operates, and the fact that subsequent acts of hostility receive the blame for the eventual contest, combine to divert judicial attention from valuation as a cause of squeeze-plays; thus the cases do not pinpoint valuation difficulties as the cause of squeeze-outs.

The two fact patterns which follow illustrate how the difficulty of valuing a business interest can set the stage for a squeeze-play. Assume for purposes of the two cases that shareholders A, B, and C each hold one-third interest in corporation X.

1. Shareholder A desires amicably to sever his connection with the business. No present dispute exists between the shareholders.[37] B and C are agreeable to A's withdrawal and are willing to buy his interest either directly or by causing corporation X to purchase it. As the corporation is closely held, its stock is not readily salable on the market, and in any event B and C do not want a stranger to acquire an interest in the corporation at this time.[38] A, B, and C sit down to arrange the purchase and to negotiate the amount to be paid for his shares. A, the prospective recipient of the purchase money, places the value of his interest at a figure considerably higher than the amount B and C are willing to pay.[39] This conflicting pecuniary interest may well lead to a disagreement which will bring the operation of the business to a standstill.[40] Sometimes through negotiation or the action of an able mediator, a compromise can be reached.

[37] Thus A may want to enter another type of business, a different business in which he hopes the return will be greater, or move to a new geographical location. Perhaps B and C want to buy out A. See Bennett v. Breuil Petroleum Corp., 99 A.2d 236 (Del. Ch. 1953).

[38] See O'Neal, Close Corporations: Law and Practice §§ 1.12, 9.02 particularly at pp. 166-167 (1958); Rohrlich, Law and Practice in Corporate Control 213 (1933).

[39] "There is something to be said for less-than-fair-value purchase of a departing stockholder's interest, sometimes called a 'cheap takeover.' While actively engaged in the business, a stockholder contributes to its growth and normally withdraws much of his interest in the form of salary. Once the active relationship is terminated by death or retirement, it may not be unreasonable to consider his interest as nominal and to value it accordingly, thereby freeing the business from draining obligations to past members." Page, Setting the Price in a Close Corporation Buy-Sell Agreement, 57 Mich. L. Rev. 655, 656 (1959).

[40] Compare 2 Bonbright, Valuation of Property 811-812 (1937).

Failure to agree can hold up A's withdrawal and cause unhappiness and dispute in other areas of the company's operations and increasing hostility between A and the other shareholders. Finally, in order to eliminate dissension and tension, B and C, as the dominant shareholders, search for some way to force A out, at the price which B and C think is fair or perhaps at a lower price to compensate for the trouble A has caused since the unsuccessful conclusion of the earlier buy-out negotiations. The result is an effort to squeeze out of the business a shareholder who originally wanted to leave voluntarily.[41]

2. Corporation X or A, B, and C as its sole shareholders receive an offer to sell the corporation's assets, to sell all of its outstanding stock, or to merge or consolidate with another corporation. If A concludes that his share of the sales price will not adequately compensate him for his interest in the business or that the terms of the merger plan are unfair to him, he may refuse to go along with the contemplated transactions. B and C believe that the transaction is advantageous to them or will benefit the corporation. They may conclude that in order to consummate the transaction they must first eliminate A from the business. Again, inability to fix with certainty the value of a business interest is the underlying cause of a squeeze-play.[42]

There are many variations on these two fact patterns and many additional situations in which valuation problems may be productive of squeeze-outs. Another typical case is where an active participant in a close corporation dies and leaves his stock to his widow. In addition to the many other problems raised by the introduction of a shareholder who is not to take an active part in running the business,[43] the impossibility of valuing the widow's interest with objectivity and precision frequently leads to attempts to eliminate the widow at what she considers to be less than the fair value of her interest. Whenever a shareholder is unable to dispose of his interest in the corporation at what he believes to be fair value, and

[41] See, e.g., Fortugno v. Hudson Manure Co., 51 N.J. Super. 482, 144 A.2d 207 (1958). Variations of this pattern occur where valuation is an underlying cause simultaneously with other factors, see Sandor Petroleum Corp. v. Williams, 321 S.W.2d 614 (Tex. Civ. App. 1959).

[42] Illustrative of this aspect of valuation as an underlying cause of squeeze-outs is the case of Matteson v. Ziebarth, 40 Wash.2d 286, 242 P.2d 1025 (1952). See also McCarthy v. Osborn, 223 La. 305, 65 So.2d 776 (1953).

[43] See, e.g., Connelly v. Weisfeld, 142 N.J. Eq. 406, 59 A.2d 869 (1948).

is unable to get the other participants to refer the matter to impartial appraisers, he may attempt to force court intervention and appraisal by petitioning for dissolution.

The difficulty in properly establishing the value of an interest in a close corporation or other small business lies in the complexity and subjective nature of any valuation process.[44] Each valuation problem is unique. As Dewing has said:

> Value is subjective; it is based on individual experience. Hence, when the individual tries to find an objective standard or criterion for his own personal values, he is confronted with endless confusion. . . . In the end the test of value is pragmatic—where does the judgment of most men meet? It is the composite of many judgments, not the reaching for an illusory fixed and invarying basis of value on which the judgment of all men should agree.[45]

Aside from business considerations, other intangible and subjective factors present themselves when an attempt is made to set the value of an interest in a business in order to arrange a sale and purchase among the shareholders or a merger or consolidation. Disagreement over assigned values frequently erupts into court action, even where external, independent appraisers are called upon for assistance.[46] When the participants negotiate among themselves, discussion and "Yankee horsetrading" marked by much give-and-take among the participants may help resolve differences. However, mere negotiation will not always enable a solution to be reached. Often "an indication of a reasonable fair market value of closely held stock will be a value which the buyer thinks is too high and the seller thinks is too low."[47] Where the figure set by a method

[44] Litigated disagreements over assigned values are frequent. See, e.g., Flynn v. Zimmerman, 23 Ill. App. 2d 467, 163 N.E.2d 568 (1960); Sorin v. Shahmoon, 152 N.Y.S.2d 521 (Sup. Ct.), aff'd, 153 N.Y.S.2d 562 (App. Div. 1956); Carr v. Carr O'Brien Co., 386 Pa. 196, 125 A.2d 607 (1956); Republic Finance & Investment Co. v. Fenstermaker, 211 Ind. 251, 6 N.E.2d 541 (1937). See also Mathilde B. Hopper, 41 B.T.A. 114 (1940); James D. McDermott, 22 T.C.M., 57 (1953). Various aspects of valuation are discussed in O'Neal, Close Corporations: Law and Practice § 7.24 (1958); Rohrlich, Organizing Corporate and Other Business Enterprises § 4.23 (3rd ed. 1958); 1 Hornstein, Corporate Law & Practice § 196 (1959); Lowndes & Kramer, Federal Estate & Gift Taxes, 499-502 (1956); Page, Setting the Price in a Close Corporation Buy-Sell Agreement, 57 Mich. L. Rev. 655, 656-660 (1959).

[45] I Dewing, The Financial Policy of Corporations 285 (4th ed. 1941). See also, Choka, Buying, Selling & Merging Businesses 44 (1958). For additional discussion of value, see 2 Bonbright, Valuation of Property 811-836 (1937); Fletcher, Private Corporations § 5890 (perm. ed. rev. repl. 1943).

[46] See Martignette v. Sagamore Mfg. Co., 163 N.E.2d 9 (Mass. 1959); Sporborg v. City Specialty Stores, 123 A.2d 121 (Del. Ch. 1956); *In re* General Realty & Utilities Corp., 29 Del. Ch. 480, 52 A.2d 6 (1947).

[47] Glunt, Valuation of Closely Held Stocks 2 (American Appraisal Company).

of valuation is unsatisfactory to one or more of the participants, that unhappiness may carry over into other areas of corporate affairs and lead to disputes on other matters[48] and ultimately to a squeeze-play.

§ 2.17. *Failure of participants to reduce all of their business bargain to writing*

The corporate charter and by-laws and the other written documents which participants in an incorporated enterprise execute frequently do not cover all aspects of their business bargain. Similarly, the articles of partnership in an unincorporated business seldom reflect the full business bargain of the members. The litigated cases show that important arrangements among participants in small business enterprises are often oral and sometimes nothing more than vague understandings, never even definitely stated orally. The law reports contain case after case in which one shareholder or group of shareholders in a close corporation have asserted claims against their associates based on violations of alleged oral agreements.[49] On the other hand, either because the parties do not clearly communicate their desires to their attorneys or because the attorneys do not draft the documents with sufficient care, some documents contain provisions which are broader and more inclusive than the parties intended.[50]

The case of *Bellows* v. *Porter*[51] illustrates how failure to cover clearly in writing all phases of the participants' business bargain can lead to strife and litigation. In that case, plaintiff, a minority shareholder, gave defendant, who held the remaining shares in the corporation, a written option to buy plaintiff's shares at their

[48] See O'Neal, Close Corporations: Law & Practice § 9.02 at 166-167 (1958); O'Neal, Oppugnancy & Oppression in Close Corporations: Remedies in America & in Britain, 1 B.C. Ind. & Comm. L. Rev. 1, 1-2 (1959). Cf. 1 Hornstein, Corporation Law & Practice 260 (1959).

[49] See, e.g., Dulin v. Pacific Wood & Coal Co., 103 Cal. 357, 35 Pac. 1045 (1894); Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App.2d 106, 202 P.2d 748 (1949); Aldridge v. Franco Wyoming Oil Co., 24 Del. Ch. 126, 7 A.2d 753, (Ch. 1939), aff'd, 24 Del. Ch. 349, 14 A.2d 380 (Sup. Ct. 1940); Martin v. Stone, 332 Mass. 540, 126 N.E.2d 196 (1955) (plaintiff contended that he and his two associates entered into an oral agreement that "no matter what might happen" the common stock ownership should remain equal and that plaintiff should suffer no financial loss "in his then position and should always retain his position so long as he chose to do so").

[50] See Stevenot v. Norberg, 210 F.2d 615 (9th Cir. 1954), where the court refused to limit the scope or effect of a by-law because of a mental reservation or unexpressed intention of the shareholders when they adopted it.

[51] 201 F.2d 429 (8th Cir., 1953).

book value and plaintiff's undated resignation as president, director, and manager of the corporation. When defendant tried to file the resignation, plaintiff claimed that the option and resignation were modified by a contemporaneous oral agreement that if defendant exercised his right to file the resignation he would simultaneously exercise the option to purchase plaintiff's shares. The court decided that defendant had merely expressed his intention to exercise the two rights simultaneously, but added that even if an oral agreement had existed it could not be given effect to modify the written contract because of the parol evidence rule.

There are many strong and rather obvious reasons why all aspects of the participants' business bargain should be reduced to writing. In the first place and perhaps most important of all, the process of planning and drafting written instruments causes the parties and their legal advisers to think through all the ramifications of the proposed relationships and make decisions on matters which otherwise might escape their attention and remain undecided. Thus hiatuses which would give rise to disputes and squeeze-outs are eliminated. Second, the existence of written documents minimizes the chance of misunderstanding and increases the probability that the parties will voluntarily comply with the terms of the bargain. The fact that the bargain is in writing has a psychological effect on the parties and tends to reduce disputes, unfounded claims, and litigation.

Finally, although oral agreements among participants in a business enterprise are generally held valid,[52] some courts appear to be somewhat more reluctant to grant specific performance of an oral agreement than of one in writing.[53]

§ 2.18. *Failure to appreciate problems that might arise out of transitions in ownership and control*

Apparently a person buying into a corporation with a number of shareholders or joining with four or five others in organizing a

[52] Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App.2d 106, 202 P.2d 748 (1949); Storer v. Ripley, 1 Misc. 2d 235, 125 N.Y.S.2d 831, aff'd. mem., 282 App. Div. 950, 125 N.Y.S.2d 339 (1953).

[53] See, e.g., Alridge v. Franco Wyoming Oil Co., 24 Del. Ch. 126, 141, 7 A.2d 753, 761 (Ch. 1939), aff'd, 24 Del. Ch. 349, 14 A.2d 380 (Sup. Ct. 1940), where the court, in denying specific performance of an alleged oral agreement, stated that "a court of equity will not compel specific performance unless the making of a contract relied on has been clearly established by the proof."

corporation not uncommonly fails to foresee that a single individual might eventually acquire a majority of the voting stock and thereby gain the power by unilateral action to squeeze out a minority shareholder. Yet time and again in cases of this kind one of the shareholders or perhaps even an outsider gradually buys up stock in the corporation until he has control.

In a typical case,[54] the general manager of a company, who initially supplied virtually none of the capital for establishing it, bought out over the years the interest of the other stockholders until he held approximately 85 per cent of the voting stock. Then he proceeded to squeeze out the holder of the other 15 per cent, a widow of one of the original incorporators who had financed the establishment of the business some thirty years before. Dividends were not paid for a period of ten years and during that time the majority shareholder ran the corporation in a one-man, autocratic manner, paying himself and other members of his family substantial salaries. The corporation did not furnish the widow with financial reports or any information on the business. The lawyer who handled this case for the widow commented that the majority shareholder "was obviously the only possible purchaser."

Sometimes a person purchasing an interest in a corporation, the majority of the stock of which is held by a man he trusts and believes he can work with congenially, does not anticipate the possibility that the majority stock will be sold to a purchaser who may not have as high ethical standards and who may take full advantage of his majority power. In all likelihood, when the time comes for the transfer of the majority interest, the minority shareholder is not in a financial position to purchase it. He is at the mercy of the purchaser. Similarly, a person taking a minority interest in a corporation apparently often does not look forward to the time when the controlling shareholder, a man in whom he has confidence, will die or retire and some younger member of the family will take over the control and operation of the business. Furthermore, dissension sometimes occurs when a son of the controlling shareholder comes into the business in an executive position, because an older and more experienced minority shareholder who has been active in the business for a long period of years resents taking orders from the son.

[54] This case was supplied by a lawyer whose name is withheld to protect the anonymity of the parties.

§ 2.19. *Businessmen's failure to obtain preventive legal services and inability of many lawyers to supply adequate preventive services*

Other sections of this chapter point out underlying causes of squeeze-outs and set forth typical situations in which squeeze-plays occur. Acting on this information, skilled lawyers, if consulted in time, should be able to decrease substantially the number of squeeze-plays by removing some of the causes of squeeze-outs and taking suitable precautionary steps to protect holders of minority interests. Unfortunately the atmosphere of optimism and good will which prevails during the initial stages of a business undertaking usually obscures the possibility of future disagreements and conflicts. Furthermore, even if the possibility of future dissension is foreseen by the participants, they are reluctant to call in legal counsel to provide against the contingency.

Legal services cost money, of course, but preventive legal advice is inexpensive when compared to the cost of litigation which may result from the failure to seek out competent legal assistance.[55] The widespread reluctance of the small businessman to obtain competent legal advice is undoubtedly a factor contributing to the number of squeeze-outs. Similarly, the fact that many lawyers do not fully understand the situations which give rise to squeeze-outs and are not thoroughly familiar with the rather complex precautions which are necessary to protect minority interests also contributes to the number of squeeze-outs.

This chapter has mentioned more or less incidentally some of the simpler precautions which can be taken to avoid dissension and guard against squeeze-plays. A later chapter[56] will be devoted to more detailed and complex devices for avoiding dissension, settling disputes when they do occur, and preventing squeeze-plays against minority interests.

Perhaps one further comment should be made, to give balance to what has already been said in this chapter. Thomas P. Murphy, a scholar and author who has devoted considerable time to the

[55] See Voorhees, Selecting a Lawyer for Your Business, Management Aids for Small Manufacturers (Oct. 1959).

[56] Chapter VII.

study of problems of small businesses, comments as follows: "One further thought, in my own observation of new enterprise I have always been impressed with the delicate mental climate that surrounds its birth. The entrepreneur needs good legal advice. But, in my judgment, it is more important to get the business started even if it is on a less than perfect basis. Legal counsel which dwells too strongly on the hazards can only cause apprehension in a human situation which calls for the best of good will and mutual trust."[57]

[57] Letter from Thomas P. Murphy, dated Oct. 17, 1959. Mr. Murphy is author of a recent book published by McGraw-Hill Book Company, Inc. entitled A Business of Your *Own*: How to Select, Finance and Start It *Successfully*.

CHAPTER III. SQUEEZE-OUT TECHNIQUES: WITHHOLDING DIVIDENDS AND EMPLOYMENT

§ 3.01. *Scope of chapter*

This chapter and the two chapters which follow it discuss the techniques which are most frequently used to squeeze out participants in small business enterprises. These three chapters also consider (and indeed this is necessary for a meaningful discussion of the squeeze techniques) the legal principles applicable to squeeze-plays and the remedies available to squeezees. As a squeeze-out may take any one of an almost infinite number of forms, the squeeze techniques discussed, although comprehensive, are not exhaustive. Other techniques undoubtedly will occur to imaginative businessmen and lawyers.

This particular chapter first gives a sort of panoramic view of squeeze-plays. It then discusses legal principles which aid squeeze-plays and make difficult the granting of relief to squeezees. Finally, it gives detailed consideration to the withholding of dividends, perhaps the most common of squeeze-out techniques, and to two other techniques to which dividend withholding is commonly coupled, namely, exclusion of squeezees from corporate employment and provision of handsome compensation for controlling shareholder-officers.

§ 3.02. *Squeeze techniques in general*

The various techniques by which persons in control of an enterprise deprive minority owners of their interest in the business or of a fair return on their investment are discussed in detail in this and subsequent chapters. Suffice it to say here, holders of a majority of the voting shares in a corporation, through their ability to elect and control a majority of the directors and to determine the outcome of shareholders' votes on other matters, have tremendous power to benefit themselves at the expense of minority shareholders. Squeezers may use any of a great variety of devices or modes of operation.

Here are a few illustrations. The squeezers may refuse to declare dividends; they may drain off the corporation's earnings in the form of exorbitant salaries and bonuses to the majority shareholder-officers and perhaps to their relatives, or in the form of high rent by the corporation for property leased from majority shareholders or unreasonable payments by the corporation under contracts between the corporation and majority shareholders not arrived at in arm's length dealings; they may deprive minority shareholders of corporate offices and of employment by the company; they may cause the corporation to sell its assets at an inadequate price to the majority shareholders or to companies in which the majority are interested; they may organize a new company in which the minority will have no interest, transfer the corporation's assets or business to it, and perhaps then dissolve the old corporation; or they may bring about the merger or consolidation of the corporation under a plan unfair to the minority. As has been indicated, the techniques listed here are merely illustrative. Furthermore, squeeze techniques are often (in fact, generally) used in various combinations.

§ 3.03. *Legal principles which obstruct relief*

American courts traditionally have been reluctant to interfere in the internal affairs of corporations, even when dissension develops among shareholders and minority shareholders claim they are being oppressed or squeezed out. In denying relief to squeezees, the courts

usually rely on one or both of the following principles: (1) the business judgment rule, or (2) the principle of majority control. Furthermore, many courts apparently feel that there is a legitimate sphere in which the controlling shareholders can act in their own interest even if the minority suffers.[1]

The business judgment rule recognizes a broad discretion in the directors to determine business policy and to conduct corporate affairs. As the late Professor Ballantine has pointed out, courts "hesitate to substitute their judgment on complicated questions of business policy for that of the elected managers of the business and have limited the scope of judicial review which they are willing to undertake."[2]

In the absence of some special control arrangement, set up by contract or special charter or by-law provision, a corporation is subject to the principle of majority rule: holders of a majority of voting shares govern. "The very foundation principle of a corporation," commented a Georgia judge many years ago, "is that the majority of its stockholders have the right to manage its affairs, so long as they keep within their chartered rights."[3]

Majority shareholders elect the directors; even under cumulative voting they elect over half the directors. The directors in turn select officers, and employees, fix their compensation, determine business policies, and manage the business. Whatever voice a minority shareholder has is purely at the grace or acquiescence of the majority.

Majority rule is modified in most states by statutory provisions requiring for fundamental corporate acts, such as charter amendments, mergers or consolidations, or sale of substantially all corporate assets, the favorable vote of holders of two-thirds or three-fourths of the shares with voting power or the vote of the holders of a specified percentage of all shares irrespective of whether the shares are given voting rights by the charter.[4] Statutes of this kind give sizable minorities protection against some of the cruder and more direct squeeze-out techniques, but they furnish no real protection against persistent and sophisticated squeeze-plays.

[1] Some of the material in this section and the authorities cited in the ensuing footnotes are taken largely from Comment, 1959 Duke L.J. 436, 437-41.

[2] Ballantine, Corporations § 231 (rev. ed. 1946).

[3] Hand v. Dexter, 41 Ga. 454, 462 (1871).

[4] See e.g., Del Code Ann. tit. 8 § 251 (1953); Ill. Ann. Stat. ch. 32 § 157.53 (Smith-Hurd 1954); Mass. Gen. Laws Ann. ch. 156 § 42 (1959); Model Bus. Corp. Act § 54 (b) (Rev. 1953).

All of this means that in general courts will not review directors' decisions in selecting corporate officers and employees, fixing salaries, declaring or withholding dividends, authorizing contracts, or otherwise fixing business policies and determining the course of corporate affairs. Courts indicate that they will aid squeezees only when acts of the majority can be characterized as fraudulent,[5] abusive of discretion,[6] unreasonable or arbitrary,[7] or in bad faith.[8] The vagueness of these standards is obviously an obstacle to a minority shareholder who seeks relief from a squeeze-play, especially as he must bear the burden of proving that the controlling shareholders or the directors have acted improperly.[9]

§ 3.04. *Withholding of dividends*

By far the most frequently used squeeze-out technique is the withholding of dividends. By suppressing dividends, majority shareholders may hope to force a minority shareholder to sell his interest to them at a price considerably less than its actual value. Sometimes the minority shareholder is bluntly told that he may as well sell out because dividends will not be paid as long as he holds the stock. On other occasions reasons why dividends cannot be paid for a long period of years are carefully fabricated and then explained to the minority shareholder. For instance, in one federal court case,[10] the squeezers informed the minority shareholders that they (the president and vice-president of the lumber company) were young men, with children of their own and with long futures ahead in the business; that they wanted to avoid double taxation by discontinuing dividends and paying themselves higher salaries and bonuses; that they intended to engage in an intensive reforestation program, together with capital improvements to the lumber mills, during which

[5] Mobile Towing & Wrecking Co. v. Hartwell, 208 Ala. 420, 95 So. 191 (1922).

[6] Jones v. Motor Sales Co., 322 Pa. 492, 185 Atl. 809 (1936).

[7] Channon v. Channon Co., 218 Ill. App. 397 (1920).

[8] Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 59 Atl. 905 (Ch. 1905); Tefft v. Schaefer, 136 Wash. 302, 239 Pac. 837 (1925).

[9] Waldrop v. Martin, 237 Ala. 556, 188 So. 59 (1939); Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 Atl. 257 (1929); Robinson v. Pittsburgh Oil Ref. Corp., 14 Del. Ch. 193, 126 Atl. 46 (1924).

[10] Johnson v. Mansfield Hardwood Lumber Co., 159 F. Supp. 104 (W.D. La. 1958), aff'd, 263 F.2d 748 (5th Cir.), rehearing denied, 268 F.2d 317, cert. denied, 361 U.S. 885 (1959). The squeeze tactics used in this case are set forth in detail in the Appendix.

there would be little or nothing in the way of funds from which to pay dividends to shareholders; and that business goals could best be accomplished if the stock were in the hands of only a few persons.

The dividend-squeeze is often applied when a minority shareholder is in financial straits, perhaps when he has his shares pledged as collateral security and will not be able to meet his obligation unless he receives dividends.[11] Even if the minority shareholder is in a sufficiently strong financial position to keep his stock for a while, he is deprived of any return on his investment during the years that dividends are withheld. As a matter of fact, to the extent that earnings are plowed back into the business, he is compelled to increase his investment in the enterprise even though returns remain at zero.[12] Thus, the minority shareholder has the choice of getting little or no return for an indefinite period on an ever-increasing investment or of selling out to majority shareholders at whatever price they offer.

Dividend withholding is usually coupled with other squeeze-techniques, most often with arrangements for high compensation and favorable employee benefits for majority shareholder-officers. The story the complaining shareholders tell varies somewhat from case to case. Thus, in a New York case[13] plaintiffs claimed that the directors, who owned the controlling stock, were withholding dividends to coerce minority shareholders into selling their shares to majority interests at a grossly inadequate price and to avoid heavy personal income taxes which majority shareholders would have to pay on dividend distributions; and that the directors by excessive salaries, bonuses, and corporate loans to themselves had eliminated their own immediate need of dividends while bringing pressure to bear on minority shareholders to sacrifice their holdings.

[11] See, e.g., Anderson v. W. J. Dyer & Bro., 94 Min. 30, 101 N.W. 1061 (1904). See also Lesnik v. Public Industrials Corp., 144 F.2d 968 (2d Cir. 1944) (success of reorganization of corporation A depended on receipt of dividends from preferred stock it held in corporation B; controlling shareholder of B caused dividends to be withheld in order to defeat reorganization of A and enable him to acquire A's holdings of B's preferred stock).

[12] This point was made, for example, by a preferred shareholder of Virginia-Carolina Chemical Corp., who in protesting against discontinuance of dividends on preferred stock gave the following statistics: "During the 12 years commencing in 1947 and extending through 1958 a total of $190.90, an average of $16 a year, was earned on each preferred share. $100 of these earnings, plus charges for depreciation, depletion and amortization of another $84, have been ploughed back into the business for a total of $184 on each preferred share." Letter from Morton M. Adler to Directors of Virginia-Carolina Chemical Corp., and others, dated Jan. 9, 1960.

[13] Gottfried v. Gottfried, 73 N.Y.S.2d 692 (Sup. Ct. 1947).

In another New York case,[14] a minority shareholder alleged that majority shareholders had conspired to obtain her stock and that in order to induce her to sell they (1) refrained from declaring a fair dividend, (2) increased their salaries as corporate officers, and (3) represented that the company had suffered reverses to such an extent that it could not pay a dividend larger than three per cent and that it probably never would be able to pay more. And in a Missouri case[15] plaintiffs alleged that dividends had not been paid for eight years, that salaries of corporate officers were excessive and had been voted without consulting plaintiffs, and that the directors had voted a bonus of one-third of the corporation's profits in excess of $4,000 before income taxes and other additional compensation to each of two shareholder-officers.

A minority shareholder who seeks to compel the directors to declare dividends must overcome a number of obstacles.[16] He may have considerable trouble establishing the facts—the amount of the corporation's earnings, what capital is needed for operation and expansion, why the directors are withholding the profits and refusing to declare dividends, and so on; and even if he succeeds in establishing the facts, he will still have difficulty in demonstrating that the facts evidence a breach of duty by the directors. The courts in general permit management—whether in a close or publicly held corporation—to exercise a high degree of discretion in two important respects.[17] First, management may exercise discretion in the choice and application of the accounting methods used to determine the existence and size of the surplus or other fund available for dividends.[18] Second, the directors are given broad discretion in deciding whether funds which the corporation's books show are legally

[14] Von Au v. Magenheimer, 126 App. Div. 257, 110 N.Y. Supp. 629 (1908), aff'd, 196 N.Y. 510, 89 N.E. 1114 (1909).

[15] Schick v. Riemer, 263 S.W.2d 51 (Mo. App. 1953).

[16] See generally on minority shareholders' power to compel dividends, Scholder, Dividends of the Minority Stockholder in a Closely-Held Corporation, 14 N.Y.U. Intra. L. Rev. 140 (1959); Note, 64 Harv. L. Rev. 299 (1950); Note, 10 Rutgers L. Rev. 723 (1956); Comment, 37 U. Det. L.J. 246 (1959).

[17] See Frey, The Distribution of Corporate Dividends, 89 U. Pa. L. Rev. 735, 736 (1941).

[18] *Ibid.* "The policy of the corporation as to depreciation, reserves and dividends is largely for the determination of the directors in good faith." Perry v. Perry, 160 N.E.2d 97, 103 (Mass. 1959). In Doherty v. Mutual Warehouse Co., 245 F.2d 609 (1957), 255 F.2d 489 (5th Cir. 1958), a corporation with an initial capitalization of only $15,000 established early in its history a policy to accumulate and set aside a surplus of $200,000 to cover unexpected business expenses and to serve as a reserve in the event of bad business years. The court refused to compel dividends in the years before the $200,000 surplus goal was reached.

available for dividends shall be distributed to the shareholders as dividends or shall be retained in the business.[19]

The doctrine is well settled that whether or not dividends are to be declared and, if so, the amount of dividends and when and how they are to be paid, are matters of internal corporation management and are primarily for the directors in their sound discretion to decide.[20] Thus, a New York court commented as follows: "Courts will not ordinarily make determinations as to whether or not corporations shall declare dividends. The internal management of a corporation rests within the sound discretion of its board of directors."[21] Similarly, an English court noted that the question of whether dividends should be declared depends upon evidence and expert opinion and concluded that "it would be a very strong measure for the Court to override the directors in such a manner."[22]

Nevertheless, there are limits to the directors' privilege to retain earnings in the business;[23] and the courts, particularly in cases involving close corporations,[24] will exercise their equity powers against arbitrary refusal of directors to declare and pay reasonable dividends. If the directors act fraudulently or in bad faith in withholding dividends, it is clear that the courts will grant equitable relief.[25] Where fraud or bad faith is absent but the directors have

[19] Ballantine, Corporations § 231 (rev. ed. 1946).

[20] Lesnik v. Public Industrials Corp., 144 F.2d 968 (2d Cir. 1944); Anderson v. Bean, 272 Mass. 432, 172 N.E. 647, 72 A.L.R. 959 (1930); Barrows v. J. N. Fauver Co., 280 Mich. 553, 274 N.W. 325 (1937); Lockley v. Robie, 301 N.Y. 371, 93 N.E.2d 895 (1950); City Bank Farmers' Trust Co. v. Hewitt Realty Co., 257 N.Y. 62, 177 N.E. 309, 76 A.L.R. 881 (1931).

[21] Lockley v. Robie, 276 App. Div. 291, 94 N.Y.S.2d 335, 339, modified and aff'd, 301 N.Y. 371, 93 N.E.2d 895 (1950).

[22] Bond v. Barrow Haematite Steel Co., [1902] 1 Ch. 353, 368.

[23] See Jones v. Van Heusen Charles Co., 230 App. Div. 694, 246 N.Y. Supp. 204 (1930). At least one state has a statute requiring the directors in the absence of a contrary charter or by-law provision to declare each year a dividend after setting aside such amount as shall have been fixed by the shareholders as working capital. See, e.g., N. M. Stat. Ann. § 51-3-16 (1953). See also Amick v. Coble, 222 N.C. 484, 23 S.E.2d 854 (1943) (dividends withheld in violation of statute requiring the payment of dividends from earnings).

[24] For an early decision requiring the directors of a close corporation to declare dividends, see Crichton v. Webb Press Co., 113 La. 167, 36 So. 926 (1904). For a more recent decision requiring directors of a close corporation to declare dividends as required by a statute providing that directors shall declare dividends of accumulated profits in excess of amount reserved as working capital, see Nebel v. Nebel, 241 N.C. 491, 85 S.E.2d 876 (1955).

[25] *In re* Brantman, 244 Fed. 101, 103 (2d Cir. 1917); W. Q. O'Neall Co. v. O'Neall, 108 Ind. App. 116, 25 N.E.2d 656 (1940); Keough v. St. Paul Milk Co., 205 Minn. 96, 285 N.W. 809 (1939); Hiscock v. Lacy, 9 Misc. 578, 30 N.Y. Supp. 860 (Sup. Ct. 1894). "Undoubtedly the malicious suppression of dividends is a wrong akin to breach of trust, for which the courts will afford a remedy." Patton v. Nicholas, 154 Tex. 385, 279 S.W.2d 848, 854 (1955). See also Lesnik v. Public Industrials Corp., 144 F.2d 968

unreasonably or arbitrarily refused to declare dividends, the decisions are in conflict on whether the courts will interfere and compel the payment of dividends.[26] It is believed, however, that most courts will require reasonably sound business judgment from the directors and some consideration for minority shareholders.[27] As was said by the Supreme Court of Indiana, "the courts will not allow the directors to use their power oppressively by refusing to declare dividends where the net profits and the condition and character of the business clearly warrant it."[28] The ultimate test, according to

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(2d Cir. 1944) (question for jury whether directors' failure to declare dividends was pursuant to a conspiracy to acquire a shareholder's stock).

"There are no infallible distinguishing earmarks of bad faith. The following facts are relevant to the issue of bad faith and are admissible in evidence: Intense hostility of the controlling faction against the minority; exclusion of the minority from employment by the corporation; high salaries, or bonuses or corporate loans made to the officers in control; the fact that the majority group may be subject to high personal income taxes if substantial dividends are paid; the existence of a desire by the controlling directors to acquire the minority stock interests as cheaply as possible. But if they are not motivating causes they do not constitute 'bad faith' as a matter of law.

"The essential test of bad faith is to determine whether the policy of the directors is dictated by their personal interests rather than the corporate welfare. Directors are fiduciaries. Their cestui que trust are the corporation and the stockholders as a body. Circumstances such as those above mentioned and any other significant factors, appraised in the light of the financial condition and requirements of the corporation, will determine the conclusion as to whether the directors have or have not been animated by personal, as distinct from corporate, considerations." Gottfried v. Gottfried, 73 N.Y.S.2d 692, 695 (Sup. Ct. 1947).

[26] Indicating that under such circumstances a court will not compel dividends: Blanchard v. Prudential Ins. Co., 80 N.J. Eq. 209, 83 Atl. 220 (Ct. Err. & App. 1912) (in the absence of fraud there is no ground for equitable interference); Gottfried v. Gottfried, 73 N.Y.S.2d 692, 695 (Sup. Ct. 1947) ("There must also be bad faith on the part of the directors."). See also Wabash Ry. v. American Refrigerator Transit Co., 7 F.2d 335 (8th Cir. 1925) (equity can interfere only if there is bad faith or clear abuse of discretion); Ballantine, Corporations § 232 (rev. ed. 1946).

Indicating that under such circumstance a court will compel dividends: Gaines v. Long Mfg. Co., 234 N.C. 331, 67 S.E.2d 355 (1951); Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 378, 59 Atl. 905, 907 (Ch. 1905) (dictum); Tefft v. Schaefer, 136 Wash. 302, 239 Pac. 837, 840 (1925) (dictum).

"It is nevertheless true that if directors unreasonably and wrongfully refuse or neglect to declare a dividend when there are surplus profits out of which it may be declared, and there is no good reason for their failure to do so, a stockholder can file a bill in a court of equity to compel the directors to declare and pay it." *In re* Brantman, 244 Fed. 101, 103 (2d Cir. 1917).

The existence of large undistributed earnings is not in itself sufficient reason for the courts to compel dividends. Stevens v. United States Steel Corp., *supra;* Marks v. Brewing Co., 126 La. 666, 52 So. 983 (1910); Schmitt v. Eagle Roller Mill Co., 199 Minn. 382, 272 N.W. 277 (1937).

[27] See Whittemore v. Continental Mills, 98 F. Supp. 387 (D. Me. 1951) (complaint alleging that board was improperly influenced by holder of majority stock who gained taxwise by withholding of dividends stated a cause for relief in equity).

[28] Star Pub. Co. v. Ball, 192 Ind. 158, 171, 134 N.E. 285, 290 (1922). "As a general rule the officials of a corporation are the sole judges as to the propriety of declaring dividends and the courts will not interfere with the proper exercise of that discretion. Yet when the right to a dividend is clear and there are funds from which it can

the Supreme Court of Minnesota, " 'resolves itself into an examination of the good faith and reasonableness of the policy of retaining that which otherwise is available for dividends.' "[29]

In deciding whether to compel the declaration of dividends, courts give great weight to the corporation's present and prospective financial needs. An Ohio court, for instance, commented that in determining whether dividends should be paid consideration should be given the needs of the business, the sums necessary for its operation until income from further operations was available, the amount of its debts and when they should be paid, and the character of its surplus assets, whether cash, credits, or merchandise.[30] Although it is difficult to find a case where relief was granted solely because the business did not need all the surplus which had been accumulated, consideration of this factor in practically every dividend-withholding opinion attests its importance.[31] In any event, whenever the withholding of amounts clearly in excess of business needs is coupled with other majority abuses, courts have forced a dividend payment.[32] On the other hand, whenever the corporation needs large amounts of working or expansion capital and majority

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properly be made, a court of equity will interfere to compel a company to declare it. Directors are not allowed to use their power illegally, wantonly, or oppressively." W. Q. O'Neall Co. v. O'Neall, 108 Ind. App. 116, 25 N.E.2d 656, 659 (1940) (preferred shareholders allowed to maintain suit to compel dividends). See also Belfast & M.L.R.R. v. City of Belfast, 77 Me. 445, 454, 1 Atl. 362 366 (1885).

[29] Keough v. St. Paul Milk Co., 205 Minn. 96, 285 N.W. 809, 821 (1939).

Note, 10 Rutgers L. Rev. 723, 725 (1956), speculates on the possibility that the doctrine of the fiduciary obligation of persons controlling the corporation to holders of minority interests may be used to protect the latter against an arbitrary dividend policy.

[30] Thomas v. Matthews, 94 Ohio St. 32, 113 N.E. 669, 675 (1916). Another court has said that whether dividends should be paid "depends usually on several considerations, is a relative question, not always susceptible of clear demonstration, and is a matter, to a considerable extent, of good judgment in conducting the company's business, and of good faith in upholding its contracts on the part of directors." Hazeltine v. Belfast & M.H.L.R.R., 79 Me. 411, 10 Atl. 328, 330 (1887). See also, Hayes v. St. Louis Union Trust Co., 317 Mo. 1028, 298 S.W. 91 (1927).

[31] See Comment, 1959 Duke L.J. 436, 438.

[32] See, e.g., Crichton v. Webb Press Co., 113 La. 167, 36 So. 926 (1904) (dividend forced because, among other reasons, the corporation had made profits of over ten times the amount of original capitalization); Anderson v. W. J. Dyer & Bro., 94 Minn. 30, 101 N.W. 1061 (1904) (dividends ordered where surplus was $70,000 upon an authorized capital of $50,000 (some of the authorized stock had not been issued) and majority shareholders were trying to defraud plaintiffs); Patton v. Nicholas, 154 Tex. 385, 279 S.W.2d 848 (1955) (dividends compelled where a corporation had accumulated a surplus of $130,000, which was almost half the amount of its capital stock, and the majority shareholder was maliciously preventing dividends in order to lower the market value of plaintiff's stock). See also Hiscock v. Lacy, 9 Misc. 578, 30 N.Y. Supp. 860 (Sup. Ct. 1894).

abuses are not present, retention of funds has been sustained.[33] Thus, a New Jersey court permitted a corporation engaged in the mill work business to withhold dividends in order to increase inventory and prepare for a building boom at the end of World War II.[34]

Among the factors relevant in determining whether a corporation has accumulated funds in excess of its needs are the following: the amount of surplus; the ratio of current assets to current liabilities; the amount of working capital needed by the business; the amount of working capital retained in prior years; business prospects; the need (if any) for expansion and the cost of any proposed expansion; and the liabilities to which the corporation is, or reasonably may be, subject in the future.[35] The utilization of such criteria to show retention of funds beyond reasonable need, however, is made exceedingly difficult by the complexities of modern business. Conceivably, a court might order payment of a dividend in spite of a need for more capital and thus compel management to raise funds from other sources; but this would, indeed, be unlikely.

Several possible remedies are available if a court can be persuaded that a corporation has improperly withheld dividends. Whenever dividend suppression has induced a minority shareholder to sell his shares to majority interests at less than their value, a court may allow him the remedies available to a defrauded seller, that is, he may be permitted either to rescind the sale or to recover from the majority shareholders as damages the difference between the price he received and the actual worth of the stock.[36] As was said by a New York court: "While the wrong now being considered was not technically a deceit, its effect was to defraud the plaintiff, and, in respect of the remedy at least, should be treated as a fraud. It was a species of fraud. By the wrongful acts of the defendants, the plaintiff was led to think that her stock was worth less than in fact it was, and we should not indulge in hair-splitting discriminations between

[33] See, e.g., Raynolds v. Diamond Mills Paper Co., 69 N.J. Eq. 299, 60 Atl. 941 (Ch. 1905); Gesell v. Tomahawk Land Co., 184 Wis. 537, 200 N.W. 550 (1924).

[34] Casson v. Bosman, 137 N.J. Eq. 532, 45 A.2d 807 (1946) (the directors may "reserve corporate profits for repairs . . . and for any other corporate necessities").

[35] The substance and language of this paragraph were largely taken from Comment, 1959 Duke L.J. 436, 439.

[36] See Von Au v. Magenheimer, 126 App. Div. 257, 110 N.Y. Supp. 629, 636 (1908), aff'd, 196 N.Y. 510, 89 N.E. 1114 (1909). See also, Johnson v. Mansfield Hardwood Lumber Co., 159 F. Supp. 104 (W.D. La. 1958), aff'd, 263 F.2d 748 (5th Cir.), rehearing denied, 268 F.2d 317, cert. denied, 361 U.S. 885 (1959), discussed in the Appendix.

that kind of deceit and a fraudulent misrepresentation or concealment respecting an existing fact, in view of the relations of the parties."[37]

Whenever the minority shareholder has kept his shares in spite of a dividend squeeze, a remedy which the courts will occasionally use when less drastic relief is not considered adequate is to place the corporation (sometimes even a prosperous one) in receivership.[38] The usual remedy, however, is an order compelling payment of a dividend. Thus a Texas appellate court eliminated the receivership and liquidation decreed by the trial court and substituted a mandatory injunction requiring the corporation and its dominant shareholder-officer to declare "a reasonable dividend at the earliest practical date."[39] Furthermore, the court's injunction ordered the payment of reasonable dividends annually thereafter whenever not clearly inconsistent with good business practice, and the court retained jurisdiction of the case for a period of five years to insure compliance.

A proceeding to force the directors to declare a dividend is equitable in nature.[40] There is a split of authority on whether such a proceeding should be brought in the name of the corporation as a derivative action[41] or whether it should be brought as a class or representative suit on behalf of all shareholders or of all shareholders in a class.[42] An attempt to get the corporation to act, unless such an attempt would have been useless, is a condition precedent to the right to bring the suit.[43]

[37] Von Au v. Magenheimer, 126 App. Div. 257, 110 N.Y. Supp. 629, 636 (1908), aff'd, 196 N.Y. 510, 89 N.E. 1114 (1909).

[38] Tower Hill-Connellsville Coke Co. v. Piedmont Coal Co., 64 F.2d 817 (4th Cir. 1933).

[39] Patton v. Nicholas, 154 Tex. 385, 279 S.W.2d 848 (1955).

[40] Lawton v. Bedell, 71 Atl. 490 (N.J. Ch. 1908).

[41] Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 20 N.E.2d 482 (1939) (a shareholder may bring a derivative suit on behalf of the corporation to have a dividend declared); Gordon v. Elliman, 306 N.Y. 456, 119 N.E.2d 331 (1954) (a suit to compel the declaration of a dividend is a derivative action and plaintiff must give security under N.Y. General Corp. Law § 61-b). See also Fletcher Cyc. Corp. (Perm. ed.) § 5326; 27 St. John's L. Rev. 360 (1953).

Some of the interesting background of the Lydia Pinkham case is set forth in Burton, Lydia Pinkham Is Her Name, chs. 6, 8 and 9 (1949).

[42] Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 59 Atl. 905 (Ch. 1905); Raynolds v. Diamond Mills Paper Co., 69 N.J. Eq. 299, 60 Atl. 941 (Ch. 1905); Ballantine, Corporations § 234 (rev. ed. 1946).

[43] Ballantine, Corporations § 234 (rev. ed. 1946). "So far as we can discover all the decisions recognizing the right to compel the declaration of dividends agree that a shareholder cannot sue without first attempting to move the corporation, unless such attempt would be useless, and that the corporation is at least a proper party to a suit brought by a shareholder." Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1,

The position of a shareholder who is trying to compel the declaration of a dividend is strengthened somewhat by the unreasonable accumulation of earnings tax. Sections 531 to 537 of the Internal Revenue Code impose a special tax on a corporation that accumulates its earnings for the purpose of relieving its shareholders from the payment of surtax to which they would be subject if the earnings were distributed as dividends.[44]

Whenever a minority shareholder believes that the corporation in which he holds shares is accumulating earnings beyond reasonable needs of the business, he can demand a dividend distribution and bring to the attention of management the risk of tax liability. If management persists in withholding dividends and the unreasonable accumulation of earnings tax is thereafter imposed on the corporation, the minority shareholder can bring a shareholders' derivative action and have a good chance of recovering for the corporation from the directors and officers the losses suffered by it from the imposition of the tax. The action might be based on one or the other of the two following grounds: (1) the directors were negligent in permitting the losses because they should have known that the tax would be imposed if earnings were not distributed; or (2) the directors and officers violated their duty of loyalty to the corporation in that they withheld dividends for personal purposes in disregard of the corporation's welfare.[45]

§ 3.05. *Eliminating minority shareholders from directorate and excluding them from company employment*

A person acquiring a substantial interest in a close corporation usually enters the business with the expectation of actively participa-

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20 N.E.2d 482, 490 (1939). "The corporation is an indispensable party to an action to compel the issuance of dividends of corporate stock, since it is the corporation's money which is to be paid out on the order of the court." Whittemore v. Continental Mills, 98 F. Supp. 387, 391 (D. Me. 1951). The United States Court of Appeals, Third Circuit, has held that directors are not necessary defendants in a suit to compel dividends. Kroese v. General Steel Castings Corp., 179 F.2d 760 (3d Cir. 1950), cert. denied, 339 U.S. 983 (1950).

[44] Int. Rev. Code 1954, §§ 531-37; Kilcullen, Taxing the Improper Accumulation of Corporate Surplus (1956); Cary, Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102 (c), 60 Harv. L. Rev. 1282 (1947) (written while the Internal Revenue Code of 1939 was in effect, but still useful).

[45] See Baker & Cary, Cases and Materials on Corporations 431-32 (3d ed. 1958). See also, Mahler v. Trico Corp., No. A.79948 (Sup. Ct. Erie Co. N.Y. Nov. 12, 1947); Notes, 49 Colum. L. Rev. 394 (1949); Note, 61 Harv. L. Rev. 1058 (1948); Comment, 37 U. Det. L.J. 246, 255-56 (1959).

ting in its affairs and serving as a key employee on a full-time basis. He might well expect to be a director and a principal officer. If dissension arises among the participants, however, majority shareholders might decide to squeeze him out. If so, they cause the directors to remove him from any corporate office he occupies and discharge him from the company's employ.[46] Directors can remove an officer or employee of the company at any time with or without cause, although the corporation will be liable for breach of whatever rights an employee might have under an employment agreement.[47]

At the next annual shareholders' meeting, majority shareholders leave the undesired shareholder off the board and elect someone in his place. Shareholders cannot without cause remove a director before the expiration of his term, unless they are given that power (and that is not usual) by charter or by-law provision;[48] but of course they may replace a director when his term (usually one year) expires. In the meantime, majority directors render the undesired member of the board relatively ineffective by methodically outvoting him.

A dividend squeeze is largely ineffective, of course, if the squeezee is drawing a substantial salary from the company. Therefore, whenever a prospective squeezee is an employee of the company, the dividend squeeze is invariably accompanied by summary termination of the squeezee's employment. On the other hand, declaration of a dividend about the time of a shareholder-employee's discharge from employment might be considered evidence that the discharge was for cause and without intent to injure the employee in his interest as a shareholder.[49]

In a leading New York case, the directors decreased the salary of one of the principal shareholders who had been serving alternatively as president and treasurer of the corporation (devoting his full time to the business) from $7,500 to $100 a year, terminated his travel allowance, and took away from him authority to transact corporate business or to sign checks against the corporation's bank

[46] See, e.g., Carr v. Kimball, 153 App. Div. 825, 139 N.Y. Supp. 253 (1912); Falfurrias Immigration Co. v. Spielhagen, 61 Tex. Civ. App. 111, 129 S.W. 164 (1910).

[47] See Model Bus. Corp. Act § 45 (Rev. 1953). Query whether directors who have discharged a shareholder-employee and have subjected the corporation to substantial liability for breach of a long-term employment contract can be made to respond in a shareholder's derivative action for losses thus caused the company.

[48] See Frank v. Anthony, 107 So.2d 136 (Fla. App. 1958); Lattin, Corporations 213 (1959).

[49] See Casson v. Bosman, 137 N.J. Eq. 532, 45 A.2d 807 (1946).

account.[50] Usually, however, a squeezee is not allowed to draw even nominal compensation from the company. In a situation of this kind, what remedies does a minority shareholder have? He cannot compel the majority shareholders to elect him a director or the directors to make him an officer, at least not in the absence of a valid shareholders' agreement so providing.[51] He cannot bring about the dissolution of the corporation except perhaps in cases of extreme abuse.[52]

§ 3.06. *Siphoning off earnings by high compensation to majority shareholders*

As has been pointed out in preceding sections, majority shareholders not uncommonly squeeze minority shareholders by withholding dividends and by excluding them from corporate positions carrying compensation. At the same time, majority shareholders escape the hardships of dividend suppression by occupying corporate offices and other key positions and compensating themselves handsomely as employees of the corporation. When "dissension and disagreement arise, the majority attempts to oust the minority, not only of control, but of a fair return upon the investment. Instead of treating all of the stock alike, and distributing the profits fairly and proportionately by way of dividends, the majority first elect themselves directors, then as directors elect themselves officers, and then distribute among themselves a substantial part of the profits in the way of excessive salaries, additional compensation and other devices."[53]

In a situation of this kind what can a minority shareholder do to force the majority shareholders to reduce their compensation and return to the corporation part of payments that have been made to them? He can bring a shareholder's derivative action based on the theory that the compensation paid and being paid constitutes a waste

[50] Lockley v. Robie, 276 App. Div. 291, 94 N.Y.S.2d 335, modified and aff'd, 301 N.Y. 371, 93 N.E.2d 895 (1950).

[51] For a discussion of shareholders' agreements designating corporate directors and officers, see O'Neal, Close Corporations: Law and Practice §§ 5.12, 5.17 (1958).

[52] See Patton v. Nicholas, 154 Tex. 385, 279 S.W.2d 848 (1955).

[53] The quotation is from Carr v. Kimball, 153 App. Div. 825, 139 N.Y. Supp. 253, 259 (1912), aff'd mem., 215 N.Y. 634, 109 N.E. 1068 (1915).

or misuse of corporate assets.[54] As a New York court has commented, the proposition is well settled "that the directors are trustees of the corporation and for all the stockholders, and may not deal with themselves for their own benefit, to the detriment of the corporation and the minority, who, by a representative action may cause the sums improperly taken to be returned to the treasury."[55] On the other hand, the directors are not barred from receiving appropriate salaries for their services as directors and officers and they are not precluded from employing their relatives for key company positions.[56]

The shareholder's suit might focus on improprieties in the method by which the compensation was fixed, particularly breaches of fiduciary duties by the directors in voting salaries to themselves in their capacities as directors, officers or employees. In a close corporation, where majority shareholders are usually also directors and officers or key employees, it is very difficult for those in control of a corporation to find a way to fix executives' compensation which will not later provide some plausible ground for attack.

Whenever a director enters into an employment contract with his corporation, his personal interest might be held to disqualify him from participating at the directors' meeting either to make up a quorum or to carry the compensation resolution by his vote.[57] The decisions are in conflict on the rule to apply when a director participates in the fixing of his own compensation. The majority view is that action fixing a director's compensation (whether for services as director or as an officer or employee) is voidable by the corporation, if his presence was needed at the directors' meeting for a quorum or his vote was necessary to pass the resolution.[58] Some courts go so far as to hold the action taken in these circumstances to be absolutely void.[59] Conversely, most courts will sustain a com-

[54] See, e.g., Ashley v. Keith Oil Corp., 73 F. Supp. 37 (D. Mass. 1947); Uccello v. Gold'n Foods, Inc. 325 Mass. 319, 90 N.E.2d 530 (1950) (minority stockholder's bill seeking, among other things, restoration of sums paid as salaries); Carr v. Kimball, 153 App. Div. 825, 139 N.Y. Supp. 253 (1912), aff'd mem., 215 N.Y. 634, 109 N.E. 1068 (1915) (representative action by minority stockholders to compel an accounting by directors).

[55] Carr v. Kimball, 153 App. Div. 825, 139 N.Y. Supp. 253, 259 (1912), aff'd mem., 215 N.Y. 634, 109 N.E. 1068 (1915).

[56] Perry v. Perry, 160 N.E.2d 97, 103 (Mass. 1959).

[57] See Lattin, Corporations 236 (1959).

[58] Moore v. Herrink, 77 F.2d 96 (4th Cir. 1935); Barrett v. Smith, 185 Minn. 596, 242 N.W. 392 (1932).

[59] Bassett v. Fairchild, 132 Cal. 637, 64 Pac. 1082, 52 L.R.A. 611 (1901); Luthy v. Ream, 270 Ill. 170, 110 N.E. 373 (1915).

pensation arrangement if the presence of the interested director was not needed to make out a quorum or his vote was not required to pass the resolution. A few liberal courts uphold the compensation, irrespective of whether the interested director's vote was necessary for the quorum or the majority necessary for passage of the resolution, if he bears the burden of showing that the compensation is fair and reasonable.[60] Furthermore, in those jurisdictions which hold a compensation contract to be voidable in the absence of a disinterested quorum and majority of directors authorizing it, an interested director may vote shares he holds for shareholder ratification of the otherwise voidable contract as long as the compensation arrangement is not fraudulent or oppressively unfair to minority shareholders.[61]

The courts have not laid down definite rules to determine the propriety of the *amount* of compensation paid corporate officers and executives; perhaps they cannot. In any event, the rules are stated in vague, elastic terms; and consequently the results reached in the decisions are not entirely consistent. It has been said that shareholders will not be permitted to take advantage of their ownership of a controlling interest in a corporation to vote themselves excessive salaries or to cause excessive salaries to be voted to them by directors under their control.[62] It has been said too that directors must act honestly and reasonably in setting the compensation of officers and executives,[63] that in fixing compensation they will not be permitted to "waste" the corporation's assets,[64] that compensation must bear some reasonable relation not only to the value of the services rendered[65] but also to the ability of the corporation to

[60] Hurt v. Cotton States Fertilizer Co., 159 F.2d 52 (5th Cir. 1947); Church v. Harnit, 35 F.2d 499 (6th Cir. 1929), cert. denied, 281 U.S. 732 (1930). For more detailed discussion of rules applicable to participation by a director in fixing his own compensation, see Lattin, Corporations 236-37 (1959); O'Neal, Close Corporations: Law and Practice § 8.10 (1958). See also Note, 38 Calif. L. Rev. 906 (1950).

[61] United States Steel Corp. v. Hodge, 64 N.J. Eq. 807, 54 Atl. 1 (Ct. Err. & App. 1903); Russell v. Henry C. Paterson Co., 232 Pa. 113, 81 Atl. 146 (1911). Cf. McKey v. Swenson, 232 Mich. 505, 205 N.W. 583 (1926) (directors' action held void and not subject to shareholder ratification).

For a discussion of the difficulty of obtaining a disinterested quorum for the fixing of executive compensation in close corporations, see O'Neal, Close Corporations: Law and Practice § 8.10 (1958).

[62] Fletcher Cyc. Corp. (Perm. ed.) § 2132.

[63] Fletcher Cyc. Corp. (Perm. ed.) § 2132. See also Barrett v. Smith, 185 Minn. 596, 242 N.W. 392, 394 (1932) (salaries of corporate officers may be so high as to evidence fraud and oppression on minority).

[64] Baker v. Cohn, 42 N.Y.S.2d 159 (Sup. Ct. 1942), modified and aff'd, 266 App. Div. 715, 40 N.Y.S.2d 623 (1943), aff'd, as modified, 292 N.Y. 570, 54 N.E.2d 689 (1944).

[65] See Nemser v. Aviation Corp., 47 F. Supp. 515 (D. Del. 1942); Schall v. Althaus,

pay,[66] and that courts of equity will review the fairness and reasonableness of compensation.[67]

Whether or not executive compensation is reasonable is a question of fact.[68] Among the factors which courts say they consider in passing on the reasonableness of compensation are the following: the executive's ability, the quantity and quality of the services he renders, the time he devotes to the company, the difficulties involved and responsibilities assumed in his work, the success he has achieved, the profits resulting to the corporation from his efforts to build up its business, the amounts under his jurisdiction, the corporation's financial condition, and increases in the volume or quality of the corporation's business.[69]

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208 App. Div. 103, 105, 203 N.Y. Supp. 36, 38 (1924). See also Swan, J., dissenting, in Rogers v. Hill, 60 F.2d 109, 113-14 (2d Cir. 1932).

[66] Backus v. Finkelstein, 23 F.2d 531, 537 (D. Minn. 1924); Baker v. Cohn, 42 N.Y.S.2d 159 (Sup. Ct. 1942), modified and aff'd, 266 App. Div. 715, 40 N.Y.S.2d 623 (1943), aff'd as modified, 292 N.Y. 570, 54 N.E.2d 689 (1944).

An interesting decision involving the propriety of profit-sharing bonuses paid director-officers and other employees after the death of the one-man owner of a company is Beacon Wool Corp. v. Johnson, 331 Mass. 274, 119 N.E.2d 195 (1954). In that case, for a number of years before the death of the owner, bonuses were paid to the two other directors and a number of employees. On the owner's death, the company lost its principal customer, but the two surviving directors continued to pay bonuses as before to themselves and the employees. The court held that in view of the precarious condition of the company after the owner's death, the payment of bonuses was constructively fraudulent, and that the directors must restore the bonuses paid to themselves and the employees.

[67] Stratis v. Anderson, 254 Mass. 536, 150 N.E. 832, 44 A.L.R. 567 (1926); Worley v. Dunkle, 2 N.J. Super, 161, 62 A.2d 699 (Ch. 1948) (fixing of salary by the sole vote of a majority shareholder is subject to review by the court of equity); Ballantine, Corporations § 76 (rev. ed. 1946). "There is no doubt . . . that this Court has the right to investigate the reasonableness of such salaries paid to officers upon a presentation of the proper facts, and when such salaries are properly called in question the burden of establishing the value thereof is upon the persons receiving the same." Riddle v. Mary A. Riddle Co., 142 N.J. Eq. 147, 59 A.2d 599, 601 (Ch. 1948).

For discussions of the amount of executive compensation deductible for income tax purposes, see Bryson and Lefevre, Tax Aspects of Executives' Compensation (1955); O'Neal, Close Corporations: Law and Practice § 8.13 (1958).

[68] Black v. Parker Mfg. Co., 329 Mass. 105, 106 N.E.2d 544 (1952).

[69] Black v. Parker Mfg. Co., 329 Mass. 105, 106 N.E.2d 544, 551 (1952); Gallin v. National City Bank, 152 Misc. 679, 273 N.Y. Supp. 87, 113 (Sup. Ct. 1934). That additional compensation would have gone to pay income tax if it had not been voted to corporate officer does not justify voting it. Hurt v. Cotton States Fertilizer Co., 159 F.2d 52 (5th Cir. 1947). Cf. Black v. Parker Mfg. Co., 329 Mass. 105, 106 N.E.2d 544 (1952) (effect of taxes on income of corporate officer and on income of the corporation properly to be considered in determining reasonableness of officer's salary). In Perry v. Perry, 160 N.E.2d 97, 101 (Mass. 1959), the court seemed to agree with findings of a master that certain increases in the compensation of executives of the company there involved "could be called excessive were it not for the fact that the amount of business done . . . showed a total of executive salaries amounting to less than five per cent and if material, I find that five per cent is the usual amount charged for executive salaries so, therefore, I am impelled to find that under the circumstances said increases were not unreasonable."

In determining whether compensation is reasonable, the courts sometimes compare the salaries in question with those paid to executives of other corporations engaged in the same type of business.[70] The courts also may examine compensation which in past years has been paid to the particular employees.[71] Whenever there has been a substantial increase in compensation, the courts not uncommonly will inquire whether there has been a proportionate increase in duties and responsibilities[72] or in corporate earnings.[73] Finally, courts may make a comparison between the salaries of employees in the controlling group and the salaries of other employees, due regard being given to job differences.[74] On the whole courts are considerably more receptive to complaints of unreasonable compensation when management is composed of shareholders who control the selection of the board of directors.[75]

In the past, courts have usually held that a corporate officer is not entitled to compensation unless his services were rendered under a contractual arrangement providing for the compensation. If his services were rendered in the absence of a contract, the corporation thereafter cannot properly pay him for those past services by bonus or otherwise.[76] Similarly, directors have been held not to have power to vote additional salary to themselves for services already performed under an employment contract specifying a particular salary.[77] And they cannot pay to themselves and other shareholder-

[70] Church v. Harnit, 35 F.2d 499 (6th Cir. 1929), cert. denied, 281 U.S. 732 (1930); Backus v. Finkelstein, 23 F.2d 531 (D. Minn. 1924), appeal dismissed, 31 F.2d 1011 (8th Cir. 1929); Stratis v. Anderson, 254 Mass. 536, 150 N.E. 832, 44 A.L.R. 567 (1926).

[71] Barrows v. J. N. Fauver Co., 280 Mich. 553, 274 N.W. 325 (1937); Luyckx v. R. L. Aylward Coal Co., 270 Mich. 468, 259 N.W. 135 (1935); Lillard v. Oil, Paint, & Drug Co., 70 N.J. Eq. 197, 56 Atl. 254 (Ch. 1903); Raynolds v. Diamond Mills Paper Co., 69 N.J. Eq. 299, 60 Atl. 941 (Ch. 1905).

[72] See Raynolds v. Diamond Mills Paper Co., 69 N.J. Eq. 299, 60 Atl. 941 (Ch. 1905), where increases in salaries for the president and secretary, from $12,000 to $15,000 and from $6,000 to $9,000 were held to be unreasonable, one reason being that there was no corresponding increase in their duties.

[73] Francis v. Brigham-Hopkins Co., 108 Md. 233, 70 Atl. 95 (1908); Esposito v. Riverside Sand & Gravel Co., 287 Mass. 185, 191 N.E. 363 (1934); Seitz v. Union Brass & Metal Mfg. Co., 152 Minn. 460, 189 N.W. 586 (1922), See Costello v. Thomas Cusack Co., 96 N.J. Eq. 95, 124 Atl. 620 (Ch. 1924), where the president was voted a salary of $50,000, an allowance of $10,000 for expenses, and a bonus of 10 per cent of the profits. It was held that this was not shown to be unreasonable because business had increased from $2,000,000 to $4,000,000 each year.

[74] Backus v. Finkelstein, 23 F.2d 531 (D. Minn. 1924), appeal dismissed, 31 F.2d 1011 (8th Cir. 1929); Davids v. Davids, 135 App. Div. 206, 120 N.Y. Supp. 350 (1909).

[75] See Seitz v. Union Brass & Metal Mfg. Co., 152 Minn. 460, 189 N.W. 586 (1922); Mortimer v. D. T. McKeithan Lumber Corp., 127 S.C. 266, 120 S.E. 723 (1923).

[76] See, e.g., Felsenheld v. Bloch Bros. Tobacco Co., 119 W. Va. 167, 192 S.E. 545 (1937).

[77] Godley v. Crandall & Godley Co., 212 N.Y. 121, 105 N.E. 818, 1915D L.R.A., 632 (1914).

employees "additional salaries" (bonuses) measured by the amount of stock held by employees rather than services rendered the company.[78] On the other hand, action of directors in increasing their own compensation for services to be rendered in the future will be sustained if the augmentation can be accounted for by the "general increase in employees' wages and salaries."[79]

In spite of their professed determination to grant relief to minority shareholders against excessive salaries of corporation officers or executives, the courts actually seldom interfere with decisions by corporate directors fixing officers' or executives' compensation.[80] This reluctance is grounded on a general disinclination to substitute their judgment for that of the directors on matters of internal management, matters which the shareholders have entrusted to the directors,[81] and on the conclusion reached by some courts that issues of the excessiveness of compensation are difficult if not impossible to resolve satisfactorily.[82] Unless the majority shareholders and the directors are clearly managing the affairs of the corporation dishonestly or the compensation payments are so unreasonable that they can be characterized as "waste" or "spoliation," the courts

[78] Godley v. Crandall & Godley Co., 212 N.Y. 121, 105 N.E. 818, 1915D L.R.A. 632 (1914). But see Bookman v. R. J. Reynolds Tobacco Co., 138 N.J. Eq. 312, 48 A.2d 646 (1946), sustaining a bonus plan under which the amount of the bonus given employees was calculated exclusively on the amount of stock owned by them.

[79] See Casson v. Bosman, 137 N.J. Eq. 532, 45 A.2d 807 (1946).

[80] Bachellor v. Olmstead, 261 Fed. 533, 536 (W.D.N.Y. 1919); Cron v. Tanner, 171 Kan. 57, 229 P.2d 1008 (1951); Riddle v. Mary A. Riddle Co., 142 N.J. Eq. 147, 59 A.2d 599 (Ch. 1948); Garbarino v. Utica Uniform Co., 269 App. Div. 622, 58 N.Y.S.2d 136 (1945), aff'd, 295 N.Y. 794, 66 N.E.2d 579 (1946); Fletcher Cyc. Corp. (Perm. ed.) § 2133.

For an analysis of the decisions relating to executive compensation in closely held companies, see Washington and Rothschild, Compensating the Corporate Executive 363-81 (rev. ed. 1951). Where relief has been granted, the compensation has usually been glaringly excessive. See, e.g., Baker v. Cohn, 42 N.Y.S.2d 159 (Sup. Ct. 1942), modified and aff'd, 266 App. Div. 715, 40 N.Y.S.2d 623 (1943), aff'd, as modified, 292 N.Y. 570, 54 N.E.2d 689 (1944), where the salaries of the officers totaled 44 per cent of the corporation's gross income and the ratio of salaries to net income ranged from 80 per cent to 102 per cent.

[81] "The court would not be authorized to substitue its judgment for theirs [the directors'] as to what are proper salaries, provided they acted in good faith within their powers, and the salaries fixed by them were not clearly excessive." Matthews v. Headley Chocolate Co., 130 Md. 523, 100 Atl. 645, 650 (1917).

The Delaware courts have laid down the following rule: "In the absence of fraud, either express or implied, the action of the governing body of a corporation, in matters of internal management . . . will not be disturbed by a Court of Equity." Hartford Acc. & Indem. Co. v. W. S. Dickey Clay Mfg. Co., 26 Del. Ch. 16, 29, 21 A.2d 178, 184 (Ch. 1941); Mercantile Trading Co. v. Rosenbaum Grain Corp., 17 Del. Ch. 325, 333-34, 154 Atl. 457, 461 (Ch. 1931); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 169, 142 Atl. 654, 660 (Ch. 1928).

[82] See Wyles v. Campbell, 77 F. Supp. 343, 350 (D. Del. 1948).

have been at a loss to find a proper reason for substituting their judgment for that of the directors.

In the typical close corporation, with its identity of ownership and management, it is probably impossible from an economic standpoint to determine what part of the earnings of the business is a return for managerial services and what part is a return on capital and a payment for entrepreneurial risk-taking.[83] Ownership and management are not in fact separated and therefore there can be no independent bargaining between the two to fix their respective shares in the returns of the business.

Some courts have been especially reluctant to overturn a profit-sharing arrangement on a claim by a minority shareholder that it is resulting in excessive compensation. This reluctance is exemplified in the following extract from an opinion of a New York court: "Contingent compensation must be distinguished from fixed salary in weighing its reasonableness. An amount which would be held wasteful if it were fixed salary will not necessarily be held spoliation or a gift if it is paid on a contingent basis—*viz.,* if determined by profits or sales volume."[84] Similarly, for tax purposes, payments which as ordinary salary would be held unreasonable and excessive may be sustained as reasonable if made under a contingent compensation agreement. On the other hand, the United States Supreme Court, in a decision involving a by-law of the American Tobacco Company providing for the payment of a percentage of the company's profits to corporate officers,[85] has indicated that reasonableness of executive compensation should be judged by the amount of the compensation at the time suit was brought rather than by the amount the profit-sharing arrangement produced at the time it was first put into operation.

[83] See Washington and Rothschild, Compensating the Corporate Executive 364-65 (rev. ed. 1951).

[84] Gottfried v. Gottfried, 112 N.Y.S.2d 431, 461 (Sup. Ct. 1952).

[85] Rogers v. Hill, 289 U.S. 582 (1933).

Chapter IV. SQUEEZE-OUT TECHNIQUES: FUNDAMENTAL CORPORATE CHANGES

§ 4.01. *Scope of chapter*

This chapter discusses squeeze-outs effectuated through fundamental corporate changes. The basic changes covered include important charter amendment, merger, consolidation, sale or lease of

substantially all corporate assets, dissolution, and reduction of capital. This chapter also discusses two transactions that are not usually classified as "fundamental changes"—bankruptcy, which can result in termination of the business or its reorganization, and issuance of additional shares, which of course can bring about basic changes in the company's financial and management structure.

State statutes generally give to holders of a majority or of a specified high percentage of the shares in a corporation (or of shares with voting rights) the power to make fundamental corporate changes or some of them. Under these statutes there is considerable leeway for majority shareholders to take unfair advantage of a minority.[1]

The risk of hardship or injustice to minority shareholders is mitigated somewhat, however, by so-called "appraisal statutes," which permit objecting shareholders to demand appraisal and purchase of their shares.[2] Minority shareholders are further protected by certain rather ill-defined equitable limitations on majority shareholder action, especially by gradually expanding fiduciary concepts which require from majority or controlling shareholders as well as directors good faith and fair dealing in the exercise of statutory powers and management functions which might adversely affect minority shareholders.[3]

Appraisal statutes are designed to protect non-assenting shareholders against being forced to accept membership in an enterprise fundamentally different from the one in which they originally invested. Furthermore, it is important to keep in mind that under appraisal statutes it is the objecting shareholders who have the election. Objecting shareholders cannot be compelled to accept the appraised value of their shares; they can choose to abide by majority action and remain with the emerging company rather than give up their interest.

Corporation statutes vary as to the shareholder vote required for particular fundamental transactions and as to the transactions which give rise to appraisal rights. In a particular jurisdiction, the shareholder vote required for merger, for example, may be greater than the vote necessary for sale of all corporate assets. Furthermore, merger may confer on non-assenting shareholders a right to have

[1] See generally, Lattin, Corporations 495-572 (1959); Lattin, Equitable Limitations on Statutory or Charter Powers Given to Majority, 30 Mich. L. Rev. 645 (1932).

[2] See generally, Note, 72 Harv. L. Rev. 1132 (1959).

[3] See Lattin, Corporations 511-515 (1959).

their shares appraised and purchased while another change will not confer that privilege. Because of such variations in procedure and legal effect, persons applying a squeeze might well find it considerably more advantageous to utilize one type of fundamental transaction rather than another. The sections which follow discuss separately each fundamental change and its serviceability as a squeeze-out device.

§ 4.02. *Charter amendment as a squeeze technique*

Charter amendment can often be used, either alone or coupled with other techniques, as a device to eliminate undesired shareholders or to alter their rights. Many corporation statutes permit charter amendments which deprive a particular class of shares of voting power, alter dividend rights, or otherwise change shareholder rights and preferences.

For instance, the Model Business Corporation Act,[4] which has been followed by most states adopting new corporation statutes in recent years, provides that a corporation may amend its charter so as to "exchange, classify, reclassify or cancel all or any part of its shares, whether issued or unissued"; to "change the preferences, limitations, and the relative rights in respect of all or any part of its shares, whether issued or unissued"; to "create new classes of shares having rights and preferences either prior and superior or subordinate and inferior to the shares of any class then authorized, whether issued or unissued"; to "cancel or otherwise affect the rights of the holders of the shares of any class to receive dividends which have accrued but have not been declared"; or to "limit, deny or grant to shareholders of any class the pre-emptive right to acquire additional or treasury shares of the corporation, whether then or thereafter authorized."[5]

The statutes often give some protection to minority shareholders by providing that a charter amendment which affects the rights or preferences of any class of shares is subject to the right of the class

[4] Prepared by the Committee on Corporate Laws of the American Bar Association.

[5] Model Business Corp. Act § 53 (f) (g) (j) (k) (p) (Rev. 1957). See also Ky. Rev. Stat. § 271.445 (1955); Md. Ann. Code art. 23, § 10 (1957); Tex. Bus. Corp. Act art. 4.01 (1956); Va. Code Ann. § 13.1-55 (Supp. 1958).

affected to vote thereon as a class.[6] Nevertheless, shareholders applying a squeeze may own or control sufficient shares of the class affected to get the required class vote. As Dean Elvin R. Latty has said: "With the virtual disappearance of 'vested rights,' and the almost limitless present-day scope of charter amendment, a shareholder holds that bundle of rights that we call his shares virtually at sufferance; votes of others may transform that bundle into one utterly, perhaps shockingly, different."[7]

§ 4.03. *Charter amendment making shares redeemable; possibility of creating redeemable common stock*

One way completely to eliminate undesired shareholders is to amend the charter to make the shares which they hold redeemable ("callable") at the option of the corporation and thereafter to cause the directors to exercise the corporation's power to redeem the stock. Undoubtedly courts will insist that the power to redeem be exercised impartially and in good faith, but in some jurisdictions courts probably will sustain the inauguration and consistent application of a practice of redemption arguably calculated to benefit the corporation, e.g., the redemption from time to time of the shares of any person reaching retirement age or for other reason ceasing to be an active employee of the company.[8]

Undesired shareholders of course often hold common stock, and that raises the rather difficult question of whether the charter can be amended to make common stock redeemable. Though the validity of charter provisions for the redemption of preferred shares is now recognized in almost all jurisdictions,[9] doubt still exists in many states on whether provision can be made for redeemable common stock.

The relevant statutes may be grouped into two general cate-

[6] See, e.g., Model Business Corp. Act § 55 (Rev. 1957); N.C. Gen. Stat. § 55-101 (Supp. 1959); Okla. Stat. tit. 18, § 1.153 (b) (1953); Wis. Stat. § 180.52 (1957).

[7] Latty, Some Miscellaneous Novelties in the New Corporation Statutes, 23 Law & Contemp. Prob. 363, 387 (1958).

[8] In Matteson v. Ziebarth, 40 Wash.2d 286, 242 P.2d 1025 (1952), the court approved a merger plan which gave to minority shareholders in a merging corporation only redeemable preferred stock in the resulting company.

[9] Dodd, Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law, 89 U. Pa. L. Rev. 697, 720 (1941).

gories.[10] One type expressly authorizes provision for the redemption of "preferred or special shares" but does not mention the redemption of common.[11] Under this type of statute, common shares have been held not to be subject to redemption.[12] The second type of statute provides that a corporation may issue two or more classes of stock with such preferences, voting powers, restrictions and qualifications as shall be fixed in the charter.[13] Although statutes of this second type do not expressly provide for the redemption of shares, they have been consistently construed to sanction redeemable preferred shares.[14] Whether this type of statute validates the redemption of common stock is more doubtful.[15]

In a leading Massachusetts case,[16] the court, applying a statute of this kind, sustained a charter clause which provided that the directors of a close corporation could by unanimous vote call any or all shares at book value. Most of the common shares of the corporation involved in that case were owned by the directors, the executives and their families, and the practice over the years had been for a retiring director or executive to sell his common shares to the corporation or to the remaining directors or executives. Eventually a retiring executive refused to comply with the established practice, and the directors exercised their privilege of calling the executive's common shares. The court refused to enjoin the redemption of the shares, holding that the provision for redemption was not an un-

[10] The remainder of this section is reprinted from O'Neal, Close Corporations: Law and Practice § 7.11 (1958). Published by Callaghan & Company, 6141 North Cicero Avenue, Chicago 46, Illinois.

[11] See, e.g., Del. Code Ann. tit. 8, § 243 (1953), § 243 (f) (Supp. 1958).

[12] Starring v. American Hair & Felt Co., 21 Del. Ch. 380, 191 Atl. 887 (Ch. 1937), aff'd, 2 A.2d 249 (Sup. Ct. 1937).

[13] See, e.g., Mass. Ann. Laws c. 156, § 14 (1959); Model Business Corporation Act § 48. See also *Id.*, §§ 59, 60. "Every business corporation shall have power to create and issue one or more classes or kinds of shares, any or all of which classes or kinds may consist of shares with par value or shares without par value, with full, limited or no voting rights, and with such designations, preferences, qualifications, privileges, limitations, options, conversion rights, and other special rights as shall be stated or authorized in the articles. Any shares subject to redemption shall be redeemable only pro rata or by lot or by such other equitable method as is selected by the board of directors. . . ." Pa. Stat. Ann. tit. 15, § 2852-601 (1958).

[14] See Crimmins & Peirce Co. v. Kidder Peabody Acceptance Corp., 282 Mass. 367, 375-76, 185 N.E. 383, 386-87 (1933); Fletcher, Cyc. Corporations § 5309 (Perm. ed.).

[15] Redeemable common stock is not permitted in Britain. Gower, Some Contrasts between British and American Corporation Law, 69 Harv. L. Rev. 1369 (1956).

[16] Lewis v. H. P. Hood & Sons, Inc., 331 Mass. 670, 121 N.E.2d 850 (1954). Cf. Greene v. E. H. Rollins & Sons, Inc., 22 Del. Ch. 394, 2 A.2d 249 (Ch. 1938) (charter clause providing for the compulsory sale of common shares to the corporation was invalidated as an unreasonable restriction on alienability). For notes critical of the Lewis case, *ante*, see 43 Geo. L. J. 302 (1955); 50 Nw. U. L. Rev. 558 (1955); 103 U. Pa. L. Rev. 819 (1955).

reasonable restraint on alienability and that the call had been exercised in good faith.

§ 4.04. *Alteration or destruction of preferences or other rights of preferred shareholders*

The rights and preferences of preferred shareholders are surprisingly susceptible to destruction or modification. Under most corporation statutes, it is clear that by charter amendment, merger, or other fundamental action preferences as to dividends can be reduced or cumulative preferred shares can be changed to noncumulative.[17] Similarly, fundamental changes have been sustained which eliminated liquidation and redemption preferences, voting rights, pre-emptive rights, and sinking fund provisions.[18]

Efforts to eliminate accrued but unpaid dividends on cumulative preferred stock have resulted in a tremendous amount of controversy and litigation.[19] Most of the litigation occurred in a ten-year period beginning about 1938.

During the depression dividends were passed year after year on cumulative preferred stock. With the return of sizable earnings just before and during World War II, common shareholders became restless and unhappy because of their inability to participate in earnings until the tremendous backlog of accumulated preferred dividends had been paid. This led to numerous efforts by managements, anxious to placate common shareholders, to utilize charter amendments, mergers, and various other devices to eliminate or subordinate the accumulated dividend claims of preferred shareholders. The story of the litigation which ensued has been adequately told elsewhere[20] and will not be repeated here. Suffice it to say for

[17] Yoakam v. Providence Biltmore Hotel Co., 34 F.2d 533 (D. R. I. 1929); Davis v. Louisville Gas & Elect. Co., 16 Del. Ch. 157, 142 Atl. 654 (1928); Lattin, Corporations 508 (1959).

[18] See Lattin, Corporations 508-11 (1959).

[19] See, e.g., Hottenstein v. York Ice Machinery Corp., 136 F.2d 944 (3d Cir. 1943); Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del. 1944); McNutly v. W. & J. Sloan, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945); Wheatley v. A. I. Root Co., 69 N.E.2d 187 (Ohio Sup. Ct. 1946); Johnson v. Lamprecht, 133 Ohio St. 567, 15 N.E.2d 127 (1938).

[20] See Becht, Corporate Charter Amendments: Issue of Prior Stock and Alterations of Dividend Rates, 50 Colum. L. Rev. 900 (1950); Dodd, Accrued Dividends in Delaware Corporations—From Vested Right to Mirage, 57 Harv. L. Rev. 894 (1944); Lattin, A Primer on Fundamental Corporate Changes, 1 W. Res. L. Rev. 3 (1949). Two articles which are particularly helpful on the question of when a plan of recapitalization is fair are: Dodd, Fair and Equitable Recapitalizations, 55 Harv. L. Rev. 870 (1942); Latty, Fairness—The Focal Point in Preferred Stock Arrearage Elimination, 29 Va. L. Rev. 1 (1942).

present purposes, the special rights and preferences of preferred stock vanish before determined attacks by common shareholders and corporate managements.[21]

§ 4.05. *Squeeze-outs through mergers and consolidations; "short merger" statutes*

A merger or consolidation is often utilized as an instrument for squeezing out minority shareholders or altering their rights and preferences.[22] Under modern corporation statutes two or more

[21] Dean Elvin R. Latty in verse entitled Corporate Canzonet, 10 Duke Bar Assn. J. 19 (1941), emphasizes the mirage-like qualities of the rights of preferred shareholders in the following apt language:

Are you ever tempted, ever stirred
To become a holder of preferred?
To own a share in a Delaware native
By buying a stock that's cumulative,
So income lost in leaner years
Is saved by virtue of arrears?
Friend, if you count on that arrearage
You'll stay at home, or travel steerage!
Arrears enjoy a legal place
Quite like the "heirs" in Shelley's Case.

When times are lean, you're apt to smile
Though dividends are passed a while,
You spend no worried, restless nights,
But comfort take in 'rearage rights,
For soon the bad times will be over,
Accruals put you back in clover.
Then dividends will be resumed
And all arrearages consumed.
Until that time your own seniority
Entitles you to full priority
Over the lowly common shares.
You'll get yours 'fore they get theirs.

Friend, you'll be a wiser, chastened man
On consummation of "The Plan."
Corporations have the means
To cleanse the common's prior liens.
For one, they can amend the charter,
Or coerce you into dubious barter,
Creating a class of Prior Preferred
That leaves your own deep, deep interred.
These tactics failing your arrears to purge,
Behold! your corporation then will merge
Into its wholly owned subsidiary,
Or using novel means discretionary,
Incorporate in another state.
You are behind the ball marked "8".

[22] Much of this section is based on Comment, 1959 Duke L.J. 436, 441-46. See also Fuld, Some Practical Aspects of a Merger, 60 Harv. L. Rev. 1092 (1947); Lattin, Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders, 30 Mich. L. Rev. 645 (1932); Lattin, Remedies of Dissenting Stockholders Under Appraisal Statutes, 45 Harv. L. Rev. 233 (1931); Comment, 45 Yale L.J. 105 (1935).

corporations can combine into a single corporation by following a prescribed procedure, even though less than all shareholders approve.[23] If this process of amalgamation results in the survival of one of the constituent corporations, the procedure is known as "merger." In other words, in a merger one or more corporations are "merged into" another corporation, the former losing legal identity but the latter surviving. On the other hand, if the surviving corporation is a new company, a new legal entity, not one of the original companies, the process is usually referred to as "consolidation." In other words, consolidation involves destruction of the companies which are combining; their assets are transferred to a new company.

Under the typical procedure for merger or consolidation, the directors of the combining companies enter into an agreement on behalf of their respective companies, setting forth the terms and conditions of the merger or consolidation, including the manner in which shares of each of the constituent corporations are to be converted into shares, securities, or obligations of the surviving corporation. This agreement is then submitted to the shareholders of each constituent corporation; and, depending on the corporation statutes in the particular jurisdiction, it must be approved by a majority or a specified proportion (often two-thirds) of each company's shareholders[24] or by a majority or specified proportion of shareholders with voting rights. If the agreement receives the required approval, it is then filed in specified public offices.

[23] At common law, fundamental corporate changes could not be made without unanimous shareholder approval. Lattin, Minority and Dissenting Shareholder's Rights in Fundamental Changes, 23 Law & Contemp. Prob. 307 (1958).

[24] See, e.g., Del. Code Ann. tit. 8, § 251 (c). The Model Business Corp. Act § 67 provides in part as follows:

[A] vote of the shareholders shall be taken on the proposed plan of merger or consolidation. Each outstanding share of each such corporation shall be entitled to vote on the proposed plan of merger or consolidation, whether or not such share has voting rights under the provisions of the articles of incorporation of such corporation. The plan of merger or consolidation shall be approved upon receiving the affirmative vote of the holders of at least two-thirds of the outstanding shares of each such corporation, unless any class of shares of any such corporation is entitled to vote as a class thereon, in which event, as to such corporation, the plan of merger or consolidation shall be approved upon receiving the affirmative vote of the holders of at least two-thirds of the outstanding shares of each class of shares entitled to vote as a class thereon and of the total outstanding shares. Any class of shares of any such corporation shall be entitled to vote as a class if the plan of merger or consolidation, as the case may be, contains any provision which, if contained in a proposed amendment to articles of incorporation, would entitle such class of shares to vote as a class.

Stockholders of an absorbed corporation may be given, in exchange for their original shares, stock of the surviving corporation with markedly different rights and preferences.[25] As a matter of fact, in a few states under so-called "short merger" statutes,[26] which permit parent corporations holding a specified high percentage of a subsidiary's stock (90 per cent under the Delaware statute) to merge with the subsidiary without the formality of shareholder votes, the parent corporation may compel the subsidiary's minority shareholders to accept cash for their shares; in a "short merger" the subsidiary's minority shareholders need not be given an interest in the resulting corporation.[27] Thus, by utilizing a "short merger" statute, a parent company can completely eliminate persons holding minority interests in subsidiaries.

The case of *Matteson* v. *Ziebarth*[28] illustrates the devastating way in which a merger can be used to oust the minority stockholder or to deprive him of his role in management. Plaintiff, a minority stockholder of Ziebarth Corporation, blocked a proposed sale of all its outstanding stock by refusing to consent to the transaction.[29] The majority stockholders then organized a dummy corporation, taking all of its outstanding common stock, and made themselves its directors. Shortly thereafter, by a two-thirds vote, the stockholders of the original corporation approved a merger with the dummy

[25] See Hottenstein v. York Ice Machinery Corp., 45 F. Supp. 436 (D. Del. 1942), aff'd, 136 F.2d 944 (3d Cir. 1943); Windhurst v. Central Leather Co., 105 N.J. Eq. 621, 149 Atl. 36 (Ch. 1930); Adams v. United States Distributing Corp., 184 Va. 134, 34 S.E.2d 244, cert. denied, 327 U.S. 788 (1945). This is sometimes justified on the ground that one who buys stock in a corporation understands that his rights and preferences may be altered by the action of a majority of shareholders. See Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A.2d 331 (Sup. Ct. 1940); 25 Wash. U.L.Q. 614 (1940). It has even been held that a provision in a stock certificate providing that a merger shall not impair the rights and preferences of the stock is invalid as in conflict with a statute which permits merger agreements that include changes in the rights and preferences of stock. See Clarke v. Gold Dust Corp., 106 F.2d 598 (3d Cir. 1939), cert. denied, 309 U.S. 671 (1939).

[26] See, e.g., Del. Code Ann. tit. 8, § 253 (1953); N.Y. Stock Corp. Law § 85.

[27] Coyne v. Park & Tilford Distillers Corp., 154 A.2d 893 (Del. Sup. Ct. 1959); Beloff v. Consolidated Edison Co. of New York, 300 N.Y. 11, 87 N.E.2d 561 (1949). See also Bingham v. Savings Investment & Trust Co., 101 N.J. Eq. 413, 138 Atl. 659 (1927).

[28] 40 Wash.2d 286, 242 P.2d 1025 (1952).

[29] The majority shareholder had arranged a deal with a larger corporation whereby it agreed to purchase all the outstanding Ziebarth stock in exchange for its own stock. The dissenter objected to the plan because it called for the purchasing corporation to hire the majority stockholder at a salary of $16,000 for eight months. The dissenting stockholder contended that part of this salary was in consideration of the agreement to sell the stock. He argued that all of the stockholders should share in this money and refused to consent to the plan. See also Outwater v. Public Service Corp., 103 N.J. Eq. 461, 143 Atl. 729 (Ch. 1928).

corporation under the terms of which each share of common stock in the original corporation was to be exchanged for one share of redeemable preferred stock of the dummy corporation, the apparent intention being to redeem the stock of the dissenter. In sustaining the merger against allegations of fraud and unfairness, the court relied on the fact that the transaction was for a lawful business purpose. Moreover, the court felt that the dissenting shareholder was not actually injured by the merger, since he had a right to have his shares appraised and purchased by the corporation.

As demonstrated in *Federal United Corporation* v. *Havender,*[30] merger can also be a potent device for erasing dividend arrearages, especially when this effect cannot be achieved by charter amendment.[31] There, plaintiffs brought a bill in equity asking the court to declare void a proposed merger of defendant corporation with its wholly owned subsidiary, where the result of the merger would have been elimination of accrued dividends on plaintiffs' stock. The merger was upheld on the ground that the elimination of accrued dividends lay within the power of the corporation[32] and on the reasoning that one who buys stock in a corporation "must be held to know that dividends may accumulate on a preferred stock, and that in the event of a merger of the corporation issuing the stock

[30] 24 Del. Ch. 318, 11 A.2d 331 (Sup. Ct. 1940).

[31] See Ballantine, Corporations § 296 (1946). In Hottenstein v. York Ice Mach. Corp., 45 F. Supp. 436 (D. Del. 1942), aff'd, 136 F.2d 944 (3d Cir. 1943), the court upheld the elimination of accrued dividends by a merger with a wholly owned subsidiary which was created for that purpose.

Thus, the holders of preferred shares with large dividend arrearages may find that the result of the merger is to wipe out their arrearages and make possible the payment of a dividend on the common stock from that future surplus from which they had expected to draw their arrearages. See generally, Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A.2d 148 (Ch. 1943); Donohue v. Heuser, 239 S.W.2d 238 (Ky. 1951); Dratz v. Occidental Hotel Co., 325 Mich. 699, 39 N.W.2d 341 (1949); Annot., 8 A.L.R.2d 893 (1949); Becht, Alterations of Accrued Dividends, 49 Mich. L. Rev. 363, 565 (1951); Comment, 47 Mich. L. Rev. 81 (1948); Note, 57 Harv. L. Rev. 894 (1944).

[32] The court said: "The state has an interest in the corporate structures under its authority. Having provided for the merger of corporations, they are not regarded with disfavor. On the contrary, mergers are encouraged to the extent that they tend to conserve and promote corporate interests. . . . Moreover, it is recognized that there may be shareholders who will be dissatisfied with the effect of the terms of the merger proposal upon the rights attached to their shares. While their right to dissent is admitted, the public policy of the state declared by the statute, somewhat analogous to the right of eminent domain, does not permit a dissenting shareholder, as against an affirmative vote of two-thirds, to veto a merger agreement if its terms are fair and equitable in the circumstances of the case. . . . The broad contention advanced by the appellees, that the merger provisions of the General Corporation Law do not authorize the extinguishment of dividends accumulated on preference stock, even if the terms of the merger proposal are fair and equitable, must be denied. . . ." Federal United Corp. v. Havender, 24 Del. Ch. 318, 334-35, 11 A.2d 331, 338-39 (Sup. Ct. 1940).

with another corporation, the various rights of shareholders, including the rights to dividends on preference stock accrued but unpaid, may, and perhaps must, be the subject of reconcilement and adjustment. . . ."[33] The court also alluded to and may have been influenced by the fact that the dissenting shareholder had the alternative of invoking an appraisal statute.

As the *Ziebarth* and *Havender* cases show, modern corporation statutes, by facilitating merger and other fundamental corporate changes, have made it easier to victimize minority interests. In mitigation of this danger, most states have adopted appraisal statutes designed to give some measure of protection to minority shareholders.[34] Theoretically, these statutes enable a stockholder who dissents from merger and certain other corporate action to have his stock appraised at a fair value and purchased by the corporation.[35] In most jurisdictions this remedy is not exclusive;[36] the dissenter may persuade the court to enjoin or set aside the merger if he can prove that the particular merger was illegal[37] or that it amounted to fraud.[38] In some states, however, the appraisal remedy is exclusive;[39]

[33] 24 Del. Ch. at 334, 11 A.2d at 338.

[34] See Chicago Corp. v. Munds, 12 Del. Ch. 142, 172 Atl. 452 (Ch. 1934), 19 Minn. L. Rev. 413. See generally, Annot., 87 A.L.R. 597 (1933); Annot., 162 A.L.R. 1237 (1946); Annot., 174 A.L.R. 960 (1948); Lattin, Remedies of Dissenting Stockholders Under Appraisal Statutes, 45 Harv. L. Rev. 233 (1931); Lattin, A Reappraisal of Appraisal Statutes, 38 Mich. L. Rev. 1165 (1940); Levy, The Rights of Dissenting Shareholders to Appraisal and Payment, 15 Cornell L.Q. 420 (1930); Notes, 38 Va. L. Rev. 915, 935 (1952); 60 Yale L. J. 337 (1951).

[35] See Chicago Corp. v. Munds, 12 Del. Ch. 142, 172 Atl. 452 (Ch. 1934), 19 Minn. L. Rev. 473; *In re* Clark's Will, 257 N.Y. 487, 178 N.E. 766 (1931); Adams v. United States Distributing Corp., 184 Va. 134, 34 S.E.2d 244, cert. denied, 327 U.S. 788 (1945); Robinson, Dissenting Shareholders: Their Rights to Dividends and the Valuation of Their Shares, 32 Colum. L. Rev. 60 (1932).

The dissenting shareholder may lose his appraisal rights by laches. National Supply Co. v. Leland Stanford Jr. University, 134 F.2d 689 (9th Cir.), cert. denied, 320 U.S. 773 (1943).

[36] Weiss v. Atkins, 52 F. Supp. 418 (S.D.N.Y. 1943), rev'd on other grounds, 149 F.2d 193 (2d Cir. 1945); Cole v. National Cash Credit Assn., 18 Del. Ch. 47, 156 Atl. 183 (1931); Wheatley v. A. I. Root Co., 79 Ohio App. 93, 72 N.E.2d 482 (1945); Dickinson v. Fire Assn., 378 Pa. 396, 106 A.2d 607 (1954).

[37] De Koven v. Lake Shore & M. S. Ry., 216 Fed. 955 (S.D.N.Y. 1914).

[38] Jones v. Missouri-Edison Elec. Co., 199 Fed. 64, aff'd, 203 Fed. 945 (8th Cir. 1913) (holding that the minority can obtain relief where the distribution of stock resulting from the merger is so unjust as to amount to a fraud upon the minority); Hottenstein v. York Ice Mach. Corp., 45 F. Supp. 436 (D. Del. 1942), aff'd, 136 F.2d 944 (3d Cir. 1943); Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A.2d 148 (Ch. 1943); Cole v. National Cash Credit Assn., 18 Del. Ch. 47, 156 Atl. 183 (Ch. 1931) (holding that fraudulent undervaluation or overvaluation of property of one of the corporations in the merger is ground for relief); Armstrong v. Hayden, 126 Misc. 786, 214 N.Y. Supp. 747 (Sup. Ct. 1926); Wick v. Youngstown Sheet & Tube Co., 46 Ohio App. 253, 188 N.E. 514 (1932).

In Robb v. Eastgate Hotel, Inc., 347 Ill. App. 261, 278, 106 N.E.2d 848, 855 (1952),

the dissenting shareholder must acquiesce in the proposed merger or accept the appraised value of his stock, although it is well known that appraisals sometimes fail to reflect the true worth of stock. The desirability of holding appraisal not to be exclusive of other remedies is supported by the fact that appraisal statutes were apparently designed to provide dissenters with a remedy which would not otherwise exist when the majority attempts a prejudicial fundamental corporate change, rather than to deprive them of those remedies which, even in the absence of the appraisal statutes, they have against irregular, illegal, or fraudulent actions of the majority.[40]

As majority interests can easily comply with the requirements of merger statutes, a shareholder who wants to prevent a merger usually must prove what most courts label "fraud," a term which is not defined with uniformity or precision. While some courts will inquire into the fairness of a merger agreement, especially if the circumstances seem to warrant close scrutiny,[41] others will set aside mergers only when unfairness is so patent as unmistakably to indicate bad faith or reckless indifference to the rights of the minority.[42]

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the court commented as follows: "Section 73 [the appraisal statute] provides an adequate remedy where the dissenting stockholders' only complaint is the inadequacy of the price received and whose only claim is for money damages—the fair value of his shares. It is not a full and adequate remedy where fraud is charged. In such cases a court of equity may go beyond the mere assessment of damages and rescind the sale. . . . Fraud is an independent ground for the exercise of equitable jurisdiction."

[39] California's appraisal statute expressly declares that appraisal is the exclusive remedy of the stockholder. Cal. Corp. Code § 4123 (West 1955). Other states have accomplished the same result by judicial construction of the statute. Beloff v. Consolidated Edison Co., 300 N.Y. 11, 87 N.E.2d 561 (1949). See also, Hubbard v. Jones & Laughlin Steel Corp., 42 F. Supp. 432 (W.D. Pa. 1941); Adams v. United States Distributing Corp., 184 Va. 134, 34 S.E.2d 244, cert. denied, 327 U.S. 788 (1945). The courts have justified this result by reasoning that the shareholder has only the right to protect his monetary interest and has no right to continue in the business.

[40] Stevens, Private Corporations § 128, at 591-97 (1949). See also Craddock-Terry Co. v. Powell, 181 Va. 417, 25 S.E.2d 363 (1943); Note, 41 Yale L.J. 908 (1932).

[41] In Outwater v. Public Service Corp., 103 N.J. Eq. 461, 143 Atl. 729 (Ch. 1928), aff'd, 104 N.J. Eq. 490, 146 Atl. 916 (Ct. Err. & App. 1924), the court refused to allow a merger because the plan would have oppressed the minority. The court indicated that the plan must be fair and equitable and that its judgment as to fairness would be influenced by the merits of the plan rather than the size of the majority which voted for it.

The fact that merging corporations are governed by interlocking directors will not necessarily result in upsetting the merger, but such a situation calls for close scrutiny. Bingham v. Savings Investment & Trust Co., 101 N.J. Eq. 413, 138 Atl. 659 (Ch. 1927); Wilson v. Rensselaer & S. R.R., 184 Misc. 218, 52 N.Y.S.2d 847 (Sup. Ct. 1945).

[42] "[T]he unfairness must be of such character and must be so clearly demonstrated as to impel the conclusion that it emanates from acts of bad faith, or a reckless indifference to the rights of others interested, rather than from an honest error of judgment." Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 133, 32 A.2d 148, 151 (Ch.

And some cases can be found which base invalidation of mergers on "constructive fraud."[43] There is, moreover, some indication that certain courts, through the stated requirement of fraud, mean to impose a more rigorous burden of proof on the protesting stockholder when a merger is involved than in other cases of corporate squeeze. Thus, while appraisal statutes assure most dissenting shareholders that they can compel the corporation to buy their shares in the event of merger, they have little chance under present law to resist with complete success sophisticated merger schemes designed to eliminate them from the business or to dilute their proprietary interests or participation in control.

§ 4.06. *Attempting to "merge" without honoring minority shareholder's appraisal rights; the doctrine of de facto merger*

As has been pointed out in the preceding section, shareholders who object to a merger are entitled to have their shares appraised and purchased; they are not required to continue in the combined corporation which results from the merger. Similarly, statutes in many states grant the same privilege to objecting shareholders in a corporation which sells, leases, or exchanges all or substantially all of its assets.[44] The statutes, however, do not give shareholders in the *purchasing* corporation—the company buying the other's assets—

1943). See Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del.), aff'd, 146 F.2d 701 (3d Cir. 1944); MacCrone v. American Capital Corp., 51 F. Supp. 462 (D. Del. 1943); Garrett v. Reid-Cashion Land & Cattle Co., 34 Ariz. 245, 270 Pac. 1044 (1928); MacFarlane v. North American Cement Corp., 16 Del. Ch. 172, 157 Atl. 396 (Ch. 1928); Outwater v. Public Service Corp., 103 N.J. Eq. 461, 143 Atl. 729 (Ch. 1928).

"The exercise of the statutory power of merger or consolidation is not usually subjected to judicial review on the ground of mere unfairness in valuation. There are, however, some judicial opinions which use general language about fairness and unfairness. . . . But there seems no tendency in the decisions toward adopting any fairness limitation. The courts are reluctant to review relative values in merger or consolidation plans. . . . Widest scope is allowed to business discretion and decisions of the majority." Ballantine, Corporations § 295, at 692 (1946).

[43] Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del.), aff'd, 146 F.2d 701 (3d Cir. 1944); Krantman v. Liberty Loan Corp., 152 F. Supp. 705 (N.D. Ill. 1956), aff'd, 246 F.2d 581 (7th Cir. 1957) (holding that a merger, which had received the necessary two-thirds vote of the stockholders, would be presumed to be fair and reasonable and could not be successfully attacked by the dissenters unless they could prove actual or constructive fraud); MacCrone v. American Capital Corp., 51 F. Supp. 462 (D. Del. 1943); Dratz v. Occidental Hotel Co., 325 Mich. 699, 39 N.W.2d 341 (1949).

[44] See, e.g., Mass. Ann. Laws ch. 156 § 46 (1959); N.J. Stat. Ann. § 14:3-5 (1939); N.Y. Stock Corp. Law § 20.

the right to appraisal, even though some shareholders consider the price paid to be unreasonably high. In a few states shareholders even in the corporation selling its assets are not entitled to appraisal.[45]

Appraisal procedures are cumbersome, and often a business cannot spare cash funds to pay dissenters the value of their holdings. Naturally efforts are made to find a way to combine businesses without incurring liabilities under the appraisal statutes. The procedure often used is somewhat as follows:[46] Corporation A sells its assets to Corporation B in return for securities of B; as part of the contract, B may assume A's obligations and A may agree to dissolve; in any event A is usually dissolved soon after the sale; A may distribute the proceeds of the sale (the B securities) to the A shareholders before it dissolves or it may distribute them after dissolution as a liquidating dividend. Especially where a sale of assets is accompanied by the purchasing company's assumption of the selling company's obligations, and followed by dissolution of the selling company, the result achieved is substantially the same as that achieved by merger or consolidation.

Whether most courts will treat sale-of-assets followed by dissolution of the selling company as a *de facto* merger is difficult to determine. A number of Delaware cases and one or two decisions in other jurisdictions[47] have refused to grant appraisal rights to shareholders of the selling corporation in such a transaction, indicating that if the formal requirements of the sale-of-assets statute are complied with, the transaction will be considered a sale rather than a merger, at least where the contract of sale does not call for dissolution and the selling corporation remains in existence long enough to receive the proceeds of the sale and distribute them to its shareholders. On the other hand, a number of decisions have applied the *de facto* merger doctrine.[48] It has been stated, however, that "even under

[45] See, e.g., Cal. Corp. Code § 3901; Del. Code Ann. tit. 8, § 271 (1953).

[46] See the provisions of the agreement of sale set forth in Heilbrunn v. Sun Chemical Corp., 150 A.2d 755, 756 (Del. Sup. Ct. 1959).

[47] See Findanque v. American Maracaibo Co., 92 A.2d 311 (Del. Ch. 1952); Argenbright v. Phoenix Fin. Co., 21 Del. Ch. 288, 187 Atl. 124 (Ch. 1936); Graeser v. Phoenix Fin. Co., 218 Iowa 1112, 254 N.W. 859 (1934). See also Heilbrunn v. Sun Chemical Corp., 150 A.2d 755 (Del. Sup. Ct. 1959) (court refused to apply *de facto* merger doctrine for benefit of shareholders in corporation *purchasing* the assets; contract of sale called for dissolution). For a detailed discussion of the authorities, see Note, 72 Harv. L. Rev. 1132, 1133-1138 (1959).

[48] Marks v. Autocar Co., 153 F. Supp. 768 (E.D. Pa. 1954) (applying Pennsylvania law); Applestein v. United, N.J.L.J., 3-31-60, p. 3 (N.J. Sup. Ct. 1960); Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25 (1958).

such a *de facto* merger doctrine, the absence of a distribution of the stock received in exchange for the assets, failure of the purchasing corporation to assume the liabilities of the seller, or omission of a provision in the contract of sale requiring dissolution would prevent the granting of appraisal rights, despite the fact that in a transaction lacking one or more of these elements a dissenting stockholder might be compelled to accept a change in his investment as substantial as if the sale had resembled a merger or consolidation in all particulars."[49]

A leading Pennsylvania case, *Farris* v. *Glen Alden Corp.,*[50] is an interesting example of how a court can use the *de facto* merger doctrine to give appraisal rights to dissenting shareholders in a corporation *purchasing* the assets of another company. In that case, Glen Alden Corporation, a Pennsylvania company, and List Industries, a Delaware holding company which had purchased large amounts of Glen Alden stock, entered into a "reorganization agreement," subject to the approval of the two sets of shareholders. The agreement contained the following provisions: (1) Glen Alden was to acquire all List Industries assets (note carefully that List, the holding company, was not acquring Glen Alden assets); (2) Glen Alden was to increase its authorized stock and issue to List several million shares of Glen Alden stock, which List would in turn distribute to its shareholders, five shares of Glen Alden in exchange for six shares of List; (3) Glen Alden was to assume List's liabilities, which included a five-million-dollar note which List had given to purchase Glen Alden stock some years before, and also outstanding stock options, incentive plans, and pension obligations; (4) the name of Glen Alden was to be changed to "List Alden Corporation"; (5) the directors of both corporations were to become directors of List Alden (as List directors would hold eleven of the seventeen directorships on the new board, this meant the List interests gained control of the emerging company); and (6) List was to be dissolved.

Shortly after this agreement was executed, notice of the annual meeting of Glen Alden was mailed to shareholders together with a proxy statement which analyzed the agreement, recommended its adoption, and recommended approval of charter amendments to implement the agreement. Plaintiff, a minority shareholder in Glen

[49] Note, 72 Harv. L. Rev. 1132, 1138 (1959).
[50] 393 Pa. 427, 143 A.2d 25 (1958).

Alden, at that point brought an action to enjoin the corporation and its officers from executing and carrying out the agreement.

Plaintiff's complaint was that the notice sent to shareholders did not comply with the corporation statute in that it failed to state that the meeting was to effect a merger and failed to notify shareholders that they had a right to dissent and claim the fair value of their shares. Under Pennsylvania law a dissenting shareholder has a right to appraisal of his shares and to have them purchased at fair value, if the corporation either merges[51] or disposes of all its assets.[52] Defendants relied, however, on 1957 amendments[53] to the Pennsylvania Corporation Act which expressly provided that shareholders of a corporation *acquiring* by purchase all or substantially all of the property of another corporation shall not be entitled to the rights and remedies of dissenting shareholders.

The Supreme Court of Pennsylvania held that the transaction was a *de facto* merger and that plaintiff was entitled to receive the fair value of his shares. The court concluded that whenever one corporation combines with another so as to lose its essential nature and alter the fundamental relationships of the shareholders among themselves and their relations to the corporation, a shareholder who does not wish to continue may treat his membership in the original corporation as terminated and have the value of his shares paid to him. As the court noted, in this case, the corporation in which plaintiff originally held shares, a coal mining company, would be transformed into a diversified holding company whose interests would range from motion picture theaters to textile companies; assets of the enterprise would be doubled and its debts increased sevenfold; control would pass to the directors of List; and plaintiff would suffer a serious financial loss as the book value of his shares would be reduced from $38 to $21 a share.

The court was of the opinion that the 1957 amendments to the Corporation Act applied only to shareholders of a corporation which acquired the property or assets of another corporation, *without more;* and that whenever, as part of a combination between two corporations, one corporation dissolves, its liabilities are assumed by the survivor, its executives and directors take over the management and control of the survivor, and its shareholders acquire the majority

[51] Pa. Stat. Ann. tit. 15, § 2852-908 (A) (1958).
[52] Pa. Stat. Ann. tit. 15, § 2852-311 (D) (1958).
[53] See Pa. Stat. Ann. tit. 15, §§ 2852-311 (F), 2852-908 (C) (1958).

of the survivor's stock, the transaction is a merger and not simply a purchase of assets or an acquisition of property. The court further commented that even if it were to be assumed that the transaction was a "sale of assets," the court still would have to recognize realities, namely, that List was acquiring Glen Alden rather than Glen Alden acquiring List, and under Pennsylvania law a Glen Alden shareholder would have the right to receive the value of his shares.[54]

Since the decision in *Farris* v. *Glen Alden Corporation,* the Pennsylvania legislature has enacted a statute which gives non-assenting shareholders of a corporation buying the assets of another company the right to demand appraisal and purchase of their shares if the transaction requires the purchasing corporation to more than double the amount of its outstanding voting stock.[55]

§ 4.07. *Disguising forced sale of shares as merger; use of merger procedure in effort to avoid compliance with "first option" rights of dissenters*

In an interesting and unusual Louisiana case,[56] majority shareholders tried to utilize the merger device to dispose of their shares without honoring a "right of first refusal" which the charter gave the other shareholder in the event they transferred their shares. Plaintiff, the minority shareholder, alleged in effect that all of the shareholders except plaintiff had agreed to sell their shares in A Corporation to B Corporation; that plaintiff objected to the sale, asserting her right to purchase the shares under a charter clause providing that whenever a holder decided to sell his shares other shareholders would have the first option to purchase them; that after plaintiff's objection to the sale majority shareholders temporarily abandoned the attempt to transfer the shares to B but agreed with B that the sale would be completed "as soon as it could be handled in a manner to avoid the objection raised by the plaintiff";[57] that thereafter the charters of both A and B were amended so as to include provisions required by

[54] 393 Pa. 427, 438, 143 A.2d 25, 31 (1958). But see Heilbrunn v. Sun Corp., 150 A.2d 755 (Del. Sup. Ct. 1959).

[55] Pa. Stat. Ann. tit. 15, § 2852-311 (F), as cited in Prentice-Hall Corporation letter of May 23, 1960.

[56] McCarthy v. Osborn, 223 La. 305, 65 So.2d 776 (1953).

[57] *Id.*, at 310, 65 So.2d at 777.

Louisiana law for their merger; and that the two corporations then entered into an agreement to carry out the terms of a so-called merger. Under the merger agreement, shareholders of A were required to sell their stock in A to B for $20 a share; they were not to receive any interest in the merged company.

Plaintiff sought to recover from her fellow shareholders losses she claimed to have suffered from their disposal of the business without recognizing her first right to buy their shares. The trial court entered judgment sustaining an exception of no cause or right of action. On appeal, the Supreme Court of Louisiana reversed, holding that "the facts alleged are sufficient to show that by the manipulation of the Board of Directors and stockholders the plaintiff was defrauded of her rights and prevented from having a proprietary interest in the so-called merged or new corporation"[58] and that the so-called merger was nothing more than a sale. The court noted that in a true merger original shareholders generally retain a proprietary interest in the resulting corporation.[59]

Perhaps, however, majority shareholders could have accomplished in "two bites" what they failed to achieve here in one. There is respectable authority to support a merger plan which gives to minority shareholders in a merging corporation only redeemable preferred stock in the resulting corporation.[60] Conceivably the redeemable preferred could later be called even though the sole or primary purpose of the redemption might be to eliminate a minority shareholder who was blocking a sale of shares or a sale of corporate assets desired by the majority.

§ 4.08. *Sale of corporate business, franchises and assets*

Under the common law unanimous shareholder approval was required for sale of all the assets of a solvent corporation.[61] All except

[58] *Id.*, at 311, 65 So.2d at 778.

[59] See, however, Beloff v. Consolidated Edison Co. of New York, 300 N.Y. 11, 19, 87 N.E.2d 561, 564 (1949), where the Court of Appeals of New York, in discussing N.Y. Stock Corp. Law § 85, authorizing mergers of electric, gas or steam corporations where the taking company owns 95 per cent or more of the merged or taken company, commented as follows: "He [minority shareholder] has no right to stay in the picture, to go along into the merger, or to share in its future benefits." See also discussion of "short merger" statutes, *supra* § 4.05.

[60] See Matteson v. Ziebarth, 40 Wash.2d 286, 242 P.2d 1025 (1952). See also, *supra* § 4.03.

[61] Des Moines Life & Annuity Co. v. Midland Ins. Co., 6 F.2d 228 (D. Minn.

a few states, however, now have statutes which permit the sale of a corporation's assets upon approval by a specified majority of shareholders.[62] The Delaware Corporation Act, for instance, provides that a corporation may sell, lease, or exchange all of its property and assets upon such terms and conditions as its board of directors deems expedient if the transaction is authorized by the holders of a majority of the stock issued and outstanding having voting power.[63] Statutes such as this, desirable though they may be in general, give majority shareholders a weapon which they can use to squeeze out a minority or unfairly reduce its participation.

Majority shareholders may organize a new corporation, taking all the shares themselves, and then cause the old company to sell its business and assets to the new company, perhaps at an inadequate price.[64] The newly organized corporation may be given a name similar to that of the old company, the directors and officers of the old company may become directors and officers of the new one, and the business may continue very much the same as before.[65] Even if the old company receives a fair price for the assets, the minority shareholders are eliminated from a prosperous going concern and are deprived of the prospect of enjoying future earnings from a promising business enterprise.

Instead of the new corporation's paying cash for the assets of the old corporation, the arrangement may be for the new company

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1925); Gottschalk v. Avalon Realty Co., 249 Wis. 78, 23 N.W.2d 606 (1946). "At common law neither the majority stockholders nor the directors could bring about a sale or cause a transfer of any portion of the property, essential for the transaction of its customary business, of a solvent, prosperous corporation, which was justifying the reason for its corporate existence, against the will of a minority however small." Eisenberg v. Central Zone Property Corp., 306 N.Y. 58, 63, 115 N.E.2d 652, 655 (1953).

The reasoning behind this rule was that each shareholder had a contractual right to have the corporation continue during its existence the purposes for which it was created. For criticism of this rule, see Ballantine, Corporations § 281 (1946). A sale of assets was originally intended as a means whereby the corporation might sell all its property for the purpose of liquidation and dissolution, but it has become an important reorganization device. See generally, Ballantine, Corporations § 279 (1946); Hills, Consolidation of Corporations by Sale of Assets and Distribution of Shares, 19 Calif. L. Rev. 349 (1931); Comment, 45 Mich. L. Rev. 34 (1947); Note, 58 Colum. L. Rev. 251 (1958).

[62] See, e.g., N.Y. Stock Corp. Law § 21 (McKinney 1952, Supp. 1959); Ohio Rev. Code Ann. § 1701.76 (Page Supp. 1959). See generally, Note, 72 Harv. L. Rev. 1132, 1133 (1959). See also Solorza v. Park Water Co., 86 Cal. App. 2d 653, 195 P.2d 523 (1948); Garbarino v. Albercan Oil Corp., 109 A.2d 824 (Del. Ch. 1954).

[63] Del. Code Ann. tit. 8 § 271 (1953).

[64] See, e.g., Ervin v. Oregon Railway and Navigation Co., 27 Fed. 625 (S.D.N.Y., 1886).

[65] See. e.g., Craddock-Terry Co. v. Powell, 180 Va. 242, 22 S.E.2d 30 (1942), modified, 181 Va. 417, 25 S.E.2d 363 (1943).

to issue its own shares or other securities to the old corporation in exchange for the assets. The old company may then retain the new company's securities or may distribute them to its own shareholders. Shareholders in the old corporation, however, cannot be compelled to accept securities in the purchasing corporation in exchange for their original shares.[66]

In most states, appraisal statutes are available to dissenters in a sale-of-assets transaction;[67] where such statutes are not deemed to afford the exclusive remedy,[68] the complaining minority may obtain equitable relief if the degree of proof, whatever that may be, required to make out fraud is satisfied.[69]

Certain factors seem to have received frequent judicial consideration in sale-of-assets cases.[70] Proof that the sole motive in making the sale was to eliminate the complaining stockholder from the corporation has been held sufficient to warrant equitable relief.[71] Although, standing alone, it has not been recognized as a ground for relief, inadequacy of consideration, too, usually has weighed in the dissenter's favor.[72] Likewise, the fact that the majority owns an in-

[66] Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); American Seating Co. v. Bullard, 290 Fed. 896 (6th Cir. 1923); Finch v. Warrior Cement Corp., 16 Del. Ch. 44, 141 Atl. 54 (1928). Cf. Treadwell v. Salisbury Mfg. Co., 7 Gray (73 Mass.) 393 (1856). An exception to this rule has been recognized where the shares received by the corporation from the purchaser are of such an established market value that they can readily be converted to cash and are thus the equivalent of cash. Geddes v. Anaconda Copper Mining Co., *supra;* Ringler v. Atlas Portland Cement Co., 301 Pa. 176, 151 Atl. 815 (1930). Cf. Craddock-Terry v. Powell, 181 Va. 417, 25 S.E.2d 363 (1943).

[67] See, e.g., N.Y. Stock Corp. Law § 21 (McKinney 1952, Supp. 1959); Ohio Rev. Code Ann. § 1701.76 (Page Supp. 1959). See also Note, 58 Colum. L. Rev. 251, 253-56 (1958).

[68] In a few instances the statutes expressly declare that the appraisal rights are exclusive in a sale situation. See Note, 58 Colum. L. Rev. 251, 254 and n. 15 (1958). In other situations, the courts have construed the appraisal statutes as the exclusive remedy of the dissenter in a sale of assets. See, e.g., Beloff v. Consolidated Edison Co., 300 N.Y. 11, 87 N.E.2d 561 (1949). The better rule, however, is that appraisal rights in a sale situation are exclusive only if there are no grounds for the court to impose equitable limitations upon the act of the majority. Fletcher, Private Corporations § 5893 (perm. ed. 1943).

[69] See Crawford v. Mexican Petroleum Co., 130 F.2d 359 (2d Cir. 1942); May v. Midwest Refining Co., 121 F.2d 431 (1st Cir. 1941); Wechler v. Valley City Mill Co., 93 F. Supp. 444 (W.D. Mich. 1950); Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del.), aff'd, 146 F.2d 701 (3d Cir. 1944); Starrett Corp. v. Fifth Ave. & Twenty-Ninth St. Corp., 1 F. Supp. 868 (S.D.N.Y. 1932); Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 Atl. 257 (1929); Allied Chem. & Dye Corp. v. Steel & Tube Co. of America, 14 Del. Ch. 11, 120 Atl. 486 (1923).

[70] See generally, Ballantine, Corporations § 285 (1946); Stevens, Corporations § 126 (1949).

[71] See Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919); Welt v. Beachcomber, Inc., 166 Misc. 29, 1 N.Y.S.2d 177 (Sup. Ct. 1937).

[72] In a sale of assets the majority owes the minority a duty to see that the assets

terest in the purchasing corporation has received the serious attention of the courts.[73]

§ 4.09. *Dissolution as a squeeze technique*

Corporation statutes commonly provide for "voluntary" dissolution whenever holders of a specified percentage of the shares approve. Under a few statutes voluntary dissolution proceedings must be conducted under court supervision[74] or court confirmation of dissolution is required.[75] Most statutes authorize dissolution without judicial supervision,[76] or give a choice, permitting dissolution under court supervision or dissolution without court participation. A typical statute[77] provides that a corporation may be dissolved by a directors' resolution recommending that the corporation be dissolved voluntarily, followed by the affirmative votes of holders of two-thirds of the corporation's outstanding shares. Under this statute, the corporation may at any time during the process of liqui-

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are sold for an adequate price. Kaye v. Kentucky Public Elevator Co., 295 Ky. 661, 175 S.W.2d 142 (1943). The adequacy of the price received for the assets is a frequent point of contention when the minority seeks to set aside the sale. It has been held that the sale is voidable if it is made for a wholly inadequate consideration, that is, when the consideration is so inadequate as to amount to fraud. Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 Atl. 257 (1929); Allied Chem. & Dye Corp. v. Steel & Tube Co. of America, 14 Del. Ch. 1, 120 Atl. 486 (1923). However, simple inadequacy of price, absent other decisive factors, is not a ground for upsetting the sale upon suit by the minority. See Homer v. Crown Cork & Seal Co., 155 Md. 66, 141 Atl. 425 (1928); Koehler v. St. Mary's Brewing Co., 228 Pa. 648, 77 Atl. 1016 (1910). It has been stated that there is a presumption that the majority will obtain an adequate price for the assets because they will also lose if the price is inadequate. See Note, 58 Colum. L. Rev. 251, 257 and n. 36 (1958). The reason for the courts' reluctance to inquire into the adequacy of the consideration is said to be the feeling that they are "controlled by the policy of giving directors and majority shareholders a wide business discretion in matters of contract and corporate management. The courts hesitate to substitute their judgment for that of the parties concerned in matters of business." Ballantine, Corporations § 285, at 673 (1946).

[73] "The presumption in favor of the fiduciary fails when, because of the relationship between him and the purchaser, his responsibilities to the corporation might be subordinated to his private interest in the sale. In such situations, the fiduciary, by making a sale for terms inequitable to the vendor, might gain special advantages, and the courts will scrutinize the sale carefully for unfairness." Note, 58 Colum. L. Rev. 251, 258 (1958). See Annot., 24 A.L.R.2d 71 (1952). See also Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921) (where the vendor corporation and purchasing corporation had a common director).

[74] See, e.g., Mass. Ann. Laws ch. 155 § 50 (1959).

[75] See, e.g., Idaho Code Ann. §§ 30-301-306 (1948).

[76] See e.g., Del. Code Ann. tit. 8, § 275 (1953, Supp. 1958); N.C. Gen. Stat. §§ 55-114-121 (Supp. 1959); Wash. Rev. Code § 23.44.010 (1951).

[77] Ill. Ann. Stat. ch. 32, §§ 157.74-.79 (Smith-Hurd 1954). See also Cal. Corp. Code § 4607 (West Supp. 1959); Conn. Gen. Stat. Rev. § 33-120 (1958); N.Y. Stock Corp. Law § 106.

dation apply to a court of equity to have the liquidation continued under the court's supervision,[78] but it is not required to do so.

Statutes permitting dissolution on the vote of a specified percentage of the shareholders, especially if dissolution is not required to be under judicial supervision, of course open the way for majority shareholders to bring about the dissolution of a company, the liquidation of its assets, and the acquisition of the assets by a concern which they own.[79] As Professor George D. Hornstein said almost twenty years ago, voluntary dissolution can be used to squeeze out small shareholders "where the corporation is obviously earning money and prospering in every way, and it is proposed, not to discontinue the business, but to turn it over to a new corporation with a slightly different name but with the same powers and some of the original owners."[80] Similarly, under so-called "dissolution-on-deadlock" statutes,[81] which authorize court dissolution of a corporation paralyzed by an even division of its shareholders or (under some statutes) by the operation of high vote requirements for shareholder or director action, holders of 50 per cent of the shares or even holders of a minority of the shares who are in a strong financial position may be able to bring about a dissolution and acquire the company's business and assets at a favorable price.

Note carefully that under some dissolution-on-deadlock statutes minority shareholders, if they are in a sufficiently strong financial position, can bring about a deadlock and then use dissolution to squeeze out majority shareholders. Note, too, that dissolution (whether of the voluntary type or under a dissolution-on-deadlock statute), unlike merger, consolidation, or (in many jurisdictions) sale of assets, does not result in appraisal rights for objecting shareholders.

The leading New York case of *Kavanaugh* v. *Kavanaugh Knitting Co.*[82] illustrates how majority shareholders can use dissolution to squeeze out a minority shareholder and what relief might be given the minority shareholder if he challenges the action in court. In

[78] Ill. Ann. Stat. ch. 32, § 157.79 (Smith-Hurd 1954).

[79] See generally Hornstein, Voluntary Dissolution—A New Development in Intracorporate Abuse, 51 Yale L.J. 64 (1941). See also Sprecher, The Right of Minority Stockholders to Prevent the Dissolution of a Profitable Enterprise, 33 Ky. L.J. 150 (1945).

[80] Hornstein, *op. cit. supra*, at 67.

[81] For a discussion of dissolution-on-deadlock statutes, see O'Neal, Close Corporations: Law and Practice § 9.29 (1958).

[82] 226 N.Y. 185, 123 N.E. 148 (1919).

that case the corporation's shares were held in equal amounts by three members of the Kavanaugh family. After dissension had arisen, two of the Kavanaughs decided to dissolve the corporation, so that they might start the business again without being encumbered with the other. Therefore they voted for dissolution, first in the capacity of directors and then as shareholders.

The minority shareholder thereupon brought an action to enjoin the continuance of the dissolution proceeding. Plaintiff alleged that dissolution was adopted in bad faith with the intention of freeing the corporation of plaintiff and of all plaintiff's rights in the business, and that defendants well knew that the corporation was exceedingly prosperous and making enormous profits.

The Court of Appeals of New York held that the complaint stated a cause of action, concluding that the dissolution statute contemplated that the directors in passing on dissolution would proceed in good faith and in the honest belief that their action would be beneficial to the corporation and the shareholders. "It is inconceivable," said the court, "that the Legislature intended that the directors, in considering and adjudging the advisability of the dissolution, might consider and hold as a basis in whole or in part for their judgment their own individual desires or interests or the mere unfriendliness or antagonism between themselves and others of the stockholders."[83] The court went on to state that since the dissolution statute gave the shareholders the ultimate power to decide whether the corporation was to be dissolved, and thereby constituted majority shareholders to that extent managers of the corporation's affairs, majority shareholders as well as the directors were "burdened and restricted by fiduciary obligations" to minority interests.[84]

In *Theis* v. *Spokane Falls Gaslight Co.,*[85] a syndicate holding most of the shares in a corporation, after failing to persuade plaintiff to sell his eight shares, passed a resolution (by a vote of more than two-thirds of the shares) for dissolution of the corporation and the sale of its property. Plaintiff attempted to enjoin sale of the property but his application for an injunction was denied and the property was sold to an agent of the syndicate. Thereafter the syndicate caused articles of incorporation to be filed for a new company which was to take over the property.

[83] 226 N.Y. at 189, 123 N.E. at 151.
[84] *Ibid.*
[85] 34 Wash. 23, 74 Pac. 1004 (1904).

At this point plaintiff filed a supplemental complaint, bringing in the new company and again applying for an injunction. The trial court denied the application but on appeal the Supreme Court of Washington, after commenting that "we are convinced beyond a doubt that the object of the attempt to dissolve the corporation was for the purpose of getting rid of uncongenial minority stockholders,"[86] remanded the cause with instructions to grant the injunction, holding that there had been no attempt at a bona fide dissolution of the corporation within the contemplation of the voluntary dissolution statute. The statute, the court indicated, does not grant absolute rights to a two-thirds majority of the shareholders to disincorporate for any reason which seems to them to be sufficient.[87] A majority cannot dissolve a prosperous corporation in order to dispossess minority shareholders of their stock by paying them its market value. In condemning what had happened here and distinguishing it from a true dissolution, the court commented:

> The practice is one which is frequently indulged in for the purpose of what is described in vulgar phrase as "freezing out" small stockholders; a compliance with the letter instead of the spirit of the statute; a pernicious practice, which courts of equity cannot too promptly condemn. A dissolution of a corporation, within the contemplation of the law, is the death of the corporation. It means a disintegration, a separation, a going out of business. But in this case all of the elements of dissolution are wanting. The corporation, with a slightly different name, proceeded in the same town, with the same property, the same powers, and substantially the same owners. All the difference is about what was testified by the president of the corporation—that after the new company was formed the minority stockholders' interest would be represented by a deposit in the bank, instead of stock in the corporation.[88]

The court further pointed out that even if plaintiff received all his stock was worth he still had a right to stay in the business and that it would be unjust to permit a small stockholder to be deprived of his profitable holdings through a sort of legal legerdemain.[89]

In the *Kavanaugh* and the *Theis* cases the relief minority shareholders obtained was an injunction against dissolution. In *Lebold* v. *Inland Steel Co.,*[90] on the other hand, minority shareholders sued

[86] 34 Wash. at 26, 74 Pac. at 1005.
[87] But see Windmuller v. Standard Distilling & Distributing Co., 114 Fed. 491 (C.C.N.J. 1902).
[88] 34 Wash. at 29-30, 74 Pac. at 1006.
[89] 34 Wash. at 33, 74 Pac. at 1006-7.
[90] 125 F.2d 369 (7th Cir. 1942).

to recover damages they suffered from dissolution of the corporation. In that case, Steamship had been operating successfully for twenty-five years, all of its boats being used to carry freight for Steel, which owned 80 per cent of its stock. Executives of Steel notified plaintiffs, minority shareholders in Steamship, that unless they sold their stock in Steamship, Steel would end all business relations with Steamship, that they must either sell their stock or see Steamship go out of business. As one witness testified, it "griped them [Steel's executives] to see that the minority stockholders were enjoying any profit."[91]

Plaintiffs refused to sell their stock. Thereupon Steel announced that it would not receive bids from Steamship to carry Steel freight, and soon thereafter Steel caused a special meeting of Steamship's shareholders to be held and voted its stock in Steamship for dissolution. Directors and officers of Steamship, being under the control of Steel, made no effort to prevent dissolution or to obtain other business for Steamship.

On the sale of Steamship's assets, consisting principally of three boats, Steel bid in the assets, apparently at their fair value. There were no other bidders. Steel immediately took possession of the boats and proceeded to carry on the transportation business without interruption or change.

The Court of Appeals, Seventh Circuit, held that a West Virginia statute authorizing dissolution did not sanction Steel's acts. "However proper a plan may be legally," the court commented, "a majority stockholder cannot, under its color, appropriate a business belonging to a corporation to the detriment of the minority stockholder. The so-called dissolution was a mere device by means of which defendant appropriated for itself the transportation business of the Steamship Company to the detriment of plaintiffs."[92]

The court granted as damages to plaintiffs the difference between what plaintiffs received from the sale of the physical assets (the boats) and what their stock was worth as stock in a going, prosperous concern continuing in business. On the measure of damages the court commented as follows:

> By taking over the assets and by continuing the prosperous business of its former cestui trust defendant has removed itself from the place where it is permissible for it to contend that there is no prosperous

[91] 125 F.2d at 372.
[92] 125 F.2d at 373.

business. That there was value over and above physical assets is perfectly obvious from the fact that a prosperous business existed and is still being conducted; that plaintiffs, if they had not been deprived of their interest, would be still sharing in the returns from the business. . . .[93]

Sometimes, too, instead of actually causing dissolution, a shareholder will simply use the threat of dissolution in applying pressure to an associate. Thus in a leading New York case,[94] dissension developed between a surviving shareholder and the widow of a deceased shareholder and he "threatened to have the corporation dissolved and to buy it in at a low price or if she should be the purchaser, that he would start a competing business."[95]

§ 4.10. *Coupling sale of assets with dissolution and other transactions; Possibility of transferring business to a company incorporated in a state where climate is favorable to a squeeze-out*

Dissolution of a corporation is of course usually followed by liquidation, i.e., the sale of corporate assets. Sometimes, however, in order to effectuate a squeeze-play, majority shareholders couple sale of assets with dissolution but cause the corporation to sell its assets before dissolution proceedings are commenced. Sale of assets and dissolution may be further combined with other transactions into arrangements which are ingenious and complex indeed.

An interesting case is *Eisenberg* v. *Central Zone Property Corp.*[96] In that case, majority shareholders, desiring to sell all the stock of a New York corporation as a unit but confronted by a minority shareholder who would not sell his interest, entered into a complicated plan to accomplish their objective. Under the plan a Delaware corporation was to be created and the New York corporation was to

[93] 125 F.2d at 374.

[94] *In re* Radom & Neidorff, Inc. 307 N.Y. 1, 119 N.E.2d 563 (1954).

[95] 307 N.Y. at 3, 119 N.E.2d at 564. See Watkins v. National Bank of Lawrence, 54 Kan. 254, 32 Pac. 914 (1893), in which a minority shareholder, instead of objecting to dissolution, complained that the directors did not exercise due diligence in winding up the company's affairs after two-thirds of the stock was voted for dissolution and that his interest as a shareholder had suffered.

[96] 306 N.Y. 58, 115 N.E.2d 652 (1953). See also Bleakney v. Schrauff, 186 N.Y.S.2d 412 (Sup. Ct. 1959) (plaintiff alleged that defendant, his fellow director and shareholder, sold all of the corporation's assets including patents and then joined with others to dissolve the corporation, with the result that plaintiff was deprived of his interest in the corporation, his interest in the patents and a claim for agreed compensation for services to the corporation).

transfer its assets to the Delaware corporation in exchange for 100 per cent of the Delaware corporation's stock. The New York corporation was to place the Delaware corporation stock it received in a voting trust, receiving voting-trust certificates.

The voting trustees were to be given power to dispose of the Delaware corporation stock as a unit. The New York corporation was then to dissolve and distribute to each of its shareholders in return for his stock in the New York corporation voting trust certificates representing the same number of shares in the Delaware corporation. Upon the sale of the stock deposited with the voting trustees, the voting trust was to terminate and the consideration received from the sale, less expenses, was to be distributed to the voting-trust certificate holders.

The minority shareholder brought a representative action on behalf of himself and other minority shareholders in the New York corporation to enjoin sale of its assets to the Delaware corporation and to vacate any transfers that had already been made. The Court of Appeals of New York held that the complaint stated a cause of action, declaring that shareholders "may not be forced out of corporations by any such method."[97]

As was pointed out by Judge Fuld in a concurring opinion,[98] the series of transactions contemplated by the plan involved far more than a "sale" or a "conveyance" of corporate assets within the meaning of the statute which authorized the sale of corporate assets and therefore there was no legislative warrant for limiting dissenters to the remedy of appraisal and payment for their stock.

The *Eisenberg* case, however, suggests the possibility that majority interests in an enterprise might cause it to change its corporate domicile from one state to another in order to obtain a legal climate more favorable to a squeeze-play. If the majority could not accomplish a squeeze-out under the laws of one jurisdiction, they might transfer the enterprise to a corporation domiciled in a state where the laws were less restrictive. The change of domicile might be effected in a number of ways, e.g., by merging the original company into a wholly owned subsidiary incorporated under the laws of another state or by sale of all corporate assets to a company organized under the laws of another jurisdiction.

[97] 306 N.Y. at 67, 115 N.E.2d at 655.
[98] 306 N.Y. at 70, 115 N.E.2d at 657.

§ 4.11. *Inadequacy of value of proportionate part of corporation's physical assets as payment for objecting shareholder's interest in dissolved corporation*

If a corporation is dissolved and its assets are purchased by another corporation and its business continued by the other company in much the same form as before, the minority shareholders who are eliminated from the enterprise may be seriously harmed even though they receive their proportionate share of the fair value of the corporation's tangible assets. This was recognized by the court in *Lebold* v. *Inland Steel Co.,*[99] discussed in a previous section.[100] The court in that case gave damages to objecting shareholders in the amount of the difference between what they had received on the sale of the physical assets of that corporation and the amount they would have received had they sold their interest in a going concern.

Obviously it is unfair to minority shareholders to deprive them of whatever expenditure they have made in connection with the organization of the corporation and of any values resulting from corporate expenditures for advertising or other activities which have resulted in good will. These points were made most forcefully many years ago by the Court of Appeals of New York in *Godley* v. *Crandall & Godley Co.*[101] In that case, after the premises of the corporation had been destroyed by fire, majority shareholders caused the corporation's assets to be transferred to a new company which they owned. "The business, the organization, the list of customers, the brands and trade names—everything pertaining to good will—were turned over without compensation to the new corporation."[102] The court held that although the majority shareholders had the right to organize another corporation, they did not have the right to conspire with directors of the old company to acquire the old company's business and good will without paying for them. After sustaining the finding of the Trial Court that the old company's good will was worth $90,000, the Court of Appeals went on to comment as follows:

[99] 125 F.2d 369 (7th Cir. 1942).
[100] *Supra,* § 4.09.
[101] 212 N.Y. 121, 105 N.E. 818 (1914). 1915D L.R.A. 632.
[102] 212 N.Y. at 135, 105 N.E. at 823, 1915D L.R.A. 632, 643.

It was the duty of the directors if they decided to discontinue the business to make an honest effort to realize on the good will. Doubtless it is true, as contended, that good will cannot exist apart from an established business. But the business was not destroyed by the fire. . . . The directors did not discharge their fiduciary duties simply by realizing on and honestly accounting for the tangible assets.[103]

§ 4.12. *Reduction of capital as a squeeze device*

Occasionally majority shareholders resort to reduction of capital in an effort to squeeze out minority interests. Thus in *Godley* v. *Crandall & Godley Co.,*[104] majority shareholders, being unable to obtain the vote of two-thirds of the shares necessary to dissolve the corporation, accomplished their purpose by reducing the corporation's capital to $15,000 and turning over the corporation's business and good will without compensation to a new corporation. Minority shareholders obtained some relief in that case,[105] recovering their proportionate part of the value of the old corporation's assets including good will; but they had to fight the case all the way to the Court of Appeals of New York in order to do so.

§ 4.13. *Use of bankruptcy proceedings to get rid of minority shareholders*

Bankruptcy proceedings can perhaps be used to effectuate a squeeze-out. Majority shareholders can cause the corporation to file a voluntary petition in bankruptcy, with the expectation that they will be able to outbid minority interests at the bankruptcy sale.

This possibility is illustrated by *Porterfield* v. *Gerstel,*[106] where the corporation, pursuant to a resolution passed by three of the corporation's five directors, filed voluntary bankruptcy proceedings.[107] The other two directors, who owned 50 per cent of the company's common stock, filed an intervention, alleging that the corporation

[103] *Ibid.*

[104] 212 N.Y. 121, 105 N.E. 818 (1914). 1915D L.R.A. 632.

[105] See discussion of the *Godley* case, *supra,* § 4.11.

[106] 222 F.2d 137 (5th Cir. 1955); 249 F.2d 634 (5th Cir. 1957). See also Porterfield v. Marden, 88 So.2d 608 (Fla. 1956).

[107] In Land v. Maxwell, 244 S.W.2d 189 (Tenn. App. 1951), a partnership organized by the majority shareholders in a corporation filed an involuntary petition in bankruptcy against the corporation.

was favorably situated financially, with assets exceeding liabilities by about $80,000, and that majority directors were using bankruptcy to squeeze out the minority.

Intervenors introduced evidence that the majority directors caused bills to be paid that were not yet due, thus dissipating corporate funds; that they told one of the intervenors not to bother about trying to make collections; and that the company's principal banker was satisfied with the bank's loan to the company. Furthermore, and perhaps most important, a disinterested witness testified that "the Mardens [majority directors] said this was not going to be a bankruptcy due to finances, it was just sort of a family argument, a civil war; that the Mardens were going to own the company and that Porterfield and Margulis [minority directors] were going to be washed out"; and that "Sonny Marden said Porterfield and Margulis tried to hold him up on selling him their stock and he was going to wipe them out—they wouldn't have a penny coming to them as far as common stock was concerned."[108]

The United States Court of Appeals, Fifth Circuit, held that the evidence adduced by minority directors in support of their intervention made out a prima facie case, commenting that "it is plain from the testimony, as it stood at the end of the hearing, that the company's financial problems really have nothing whatever to do with the filing of the voluntary bankruptcy petition."[109] Furthermore, the Court recognized that bankruptcy proceedings can be utilized for quick elimination of undesired shareholders, observing that "the very summary nature of the proceedings in the bankruptcy Court, which in this case permitted the Mardens and Pass to buy into a successfully operating corporation, put it into bankruptcy within four weeks and to obtain an order for the sale of its assets two weeks later, such sale being delayed only because of the filing of this intervention, and actually followed by a sale in less than two months from the filing of the petition, makes it necessary for the courts to prevent, so far as possible, any abuse of this procedure."[110]

The Court of Appeals remanded the case to the District Court to conduct further hearings to afford the trustee in bankruptcy and the corporation an opportunity to meet the prima facie case. In compliance with this mandate, the District Court held additional

[108] 222 F.2d at 141.
[109] 222 F.2d at 142.
[110] 222 F.2d at 141.

hearings at which five new witnesses for the majority directors testified to the following effect: the company was insolvent in the equity sense, i.e., it could not pay its bills as they matured; it was borrowing money from its officers; and majority directors had made unsuccessful efforts to establish a line of credit for the company.[111]

On the basis of this testimony, the District Court dismissed the minority directors' petition to vacate the bankruptcy adjudication. The Court of Appeals affirmed, concluding that it could no longer say that "the company's financial problems really had nothing whatever to do with the filing of the voluntary bankruptcy petition."[112] Thus, the result of this hotly contested litigation was that shareholders holding 50 per cent of the corporation's common stock were eliminated from the enterprise, even though there was considerable evidence that the primary reason for resorting to bankruptcy was to squeeze out undesired shareholders.[113]

§ 4.14. *Dilution of minority shareholders' interests through issuance of new stock*

Majority shareholders can often diminish the minority's proportionate voting rights and proportionate claim on earnings and assets by causing the issuance of additional shares of stock and controlling the disposition of the new shares.[114] Assume that X owns 100 shares in B Corporation, which has 1,000 shares of capital stock outstanding, and that Y and Z each own 450 shares. If Y and Z cause the corporation to issue an additional 1,000 shares of stock, which they in some way acquire for themselves, obviously they cut in half the percentage of the business owned by X. Repeated issues of stock can of course result in further dilution of X's interest.

The new issue of shares may consist of originally authorized but unissued shares, shares newly authorized by charter amendment, or

[111] 249 F.2d 634, 635-36 (5th Cir. 1957).

[112] 249 F.2d at 635.

[113] In some states the corporation act makes it possible to effectuate a plan of reorganization in bankruptcy when it has been confirmed by order of the court, without further action by its directors or shareholders, provided the action to be taken under the approved plan is such as is authorized by the laws of the states. The act may also provide that if the reorganization is effected pursuant to the Federal Bankruptcy Act, non-assenting shareholders shall not be entitled to appraisal rights but shall have only such rights as are provided in the plan of reorganization. See, e.g., N.Y. Stock Corp. Law § 26. Such statutory provisions seem to open up an additional opportunity for squeeze-plays.

[114] See, e.g., Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951).

shares which the corporation has reacquired and holds uncanceled in its treasury ("treasury shares"). Usually the new stock is issued at less than its fair value (often at par).[115] It may be issued at a time when the minority is financially unable to purchase its proportionate part of the issue.[116]

A minority shareholder is afforded some protection by the shareholder's pre-emptive right. This right, though subject to many exceptions, in general gives to each shareholder an option to subscribe to a new allotment of shares (in the proportion that his holdings bear to total shares outstanding) before the new shares are offered to other persons.[117] Thus, in the example just given, X would have a pre-emptive right to purchase 100 shares of the new issue. By exercising his right to purchase, X would preserve his 10 per cent interest in the business.

The utility of the shareholder's pre-emptive right as a shield against squeeze-outs, however, is considerably impaired by the numerous exceptions to the right.[118] In most states the pre-emptive right can be denied or limited by charter provision.[119] A shareholder faced with a squeeze play might well find that the pre-emptive right has been abolished in his corporation by charter clause. And even in the absence of charter limitation, there are many situations in which the shareholder's pre-emptive right does not apply. The right is usually held not to attach to issues of non-voting stock.[120] Furthermore, it does not attach to stock issued in exchange for property the corporation needs[121] or (according to some authorities) to stock

[115] Schwab v. Schwab-Wilson Mach. Corp., 13 Cal. App.2d 1, 55 P.2d 1268 (1936); Bennett v. Breuil Petroleum Corp., 99 A.2d 236 (Del. Ch. 1953).

[116] Bellows v. Porter, 201 F.2d 429 (8th Cir. 1953); Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951); Maguire v. Osborne, 388 Pa. 121, 130 A.2d 157 (1957).

[117] See Thom v. Baltimore Trust Co., 158 Md. 352, 148 Atl. 234 (1930), 39 Yale L. J. 905; Steven v. Hale-Haas Corp., 249 Wis. 205, 23 N.W.2d 620 (1946); Hammer v. Cash, 172 Wis. 185, 178 N.W. 465 (1920); 15 Fletcher, Cyc. Corporations § 5135 (perm. ed. 1938).

[118] See Note, 40 Cal. L. Rev. 132, 139 (1952).

[119] See, e.g., Cal. Corp. Code § 1106 (West 1955); N.Y. Stock Corp. Law § 39; Ohio Rev. Code Ann. § 1701.15 (Page 1954); Okla. Stat. Ann. tit. 18, § 1.45 (perm. ed. 1953); Wis. Stat. § 180.21 (1955).

[120] See Yoakam v. Providence Biltmore Hotel Co., 34 F.2d 533 (D.R.I. 1929); Frey, Shareholders' Pre-emptive Rights, 38 Yale L. J. 563 (1929). See, as to preferred shares, Tennant v. Epstein, 271 Ill. App. 204, rev'd on other grounds, 356 Ill. 26, 189 N.E. 864 (1934). See generally, Ballantine, Corporations, § 209 (rev. ed. 1946).

[121] Thom v. Baltimore Trust Co., 158 Md. 352, 148 Atl. 234 (1930), 39 Yale L.J. 905, is one of the leading cases. See also Meredith v. New Jersey Zinc & Iron Co., 55 N.J. Eq. 211, 37 Atl. 539 (Ch. 1897). For a severe criticism of this exception, see Frey, Shareholders' Pre-emptive Rights, 38 Yale L.J. 563, 579 (1929).

issued in satisfaction of a pre-existing debt.[122] Sophisticated squeezers can of course circumvent a minority shareholder's pre-emptive right by causing the corporation to issue the new stock to them, their relatives, or friends in return for property; or they can make a loan to the corporation and after the lapse of a "decent" interval cause the corporation to satisfy the debt by issuing shares to them.

It is also generally accepted that the pre-emptive right does not apply to an allotment of authorized but previously unissued shares[123] or to the reissue of treasury stock.[124] These exceptions are important because in many instances the number of unissued shares or the number of treasury shares may be sufficient (when added to the holdings of a particular group of shareholders) to give those shareholders a clear majority of the voting shares or to give them the two-thirds or other statutory majority necessary to effect a merger or other fundamental corporate action.[125]

Occasionally the directors or majority shareholders try to get persons comprising the minority to waive their pre-emptive rights.[126] There may be legitimate business reasons for waiving pre-emptive rights, but a minority shareholder should be very cautious in giving up that right. Even if directors or majority shareholders do not have a squeeze-out in mind at the time they solicit the waiver, the possibility of effecting a squeeze-out may occur to them later.

In a squeeze-out through the issuance of additional shares the

[122] Musson v. New York & Queens Elec. Light & Power Co., 138 Misc. 881, 247 N.Y. Supp. 406 (1931). *Contra,* Hodge v. Cuba Co., 142 N.J. Eq. 340, 60 A.2d 88 (1948).

[123] Yasik v. Wachtel, 25 Del. Ch. 247, 17 A.2d 309 (1941), 40 Mich. L. Rev. 115 (1941); Ross Transport, Inc. v. Crothers, 185 Md. 573, 45 A.2d 267 (1946); Dunlay v. Avenue M. Garage & Repair Co., 253 N.Y. 274, 170 N.E. 917 (1930).

[124] Borg v. International Silver Co., 11 F.2d 147 (2d Cir. 1925); Crosby v. Stratton, 17 Colo. App. 212, 68 Pac. 130 (1902). Fletcher, Cyc. Corporations § 5136.2 (perm. ed.).

[125] In Dunlay v. Avenue M. Garage & Repair Co., 253 N.Y. 274, 170 N.E. 917 (1930), a majority of the board of directors voted to issue fifty of the close corporation's seventy-six remaining authorized but unissued shares to one of the corporation's salesmen in payment for services rendered the corporation. The majority also authorized the issuance of the other twenty-six shares to one of the directors in exchange for cash to meet the corporation's outstanding indebtedness. This director and his faction later acquired the fifty shares issued the salesman, which, together with seventy-six shares later purchased from another stockholder, were sufficient to give the director's faction control of the corporation. The court found that since the stock issuance was for a "reasonably necessary purpose," there was no breach of trust in not offering the other stockholders a proportionate share of the issuance.

[126] See, however, Gord v. Iowana Farms Milk Co., 245 Iowa 1, 60 N.W.2d 820 (1953). In that case, a shareholder, who had not been told the price at which the new stock would be issued, signed a statement that he did not want to purchase any of close corporation's newly authorized stock. After the new stock had been issued at a fraction of the original stock's value, the court held that shareholder had not waived his pre-emptive right since he was not made aware of the diluting effect the new issue would have on his holdings.

corporation's management typically claims that it needs additional capital for expansion or the payment of debts. Sometimes management will couch applications for bank loans in terms which encourage denial of the loans,[127] in order to make sale of shares to preferred individuals appear more imperative.

The new shares are usually offered at par, which almost invariably happens to be considerably below their actual value; a sale at par "creates some appearance that the consideration received for the shares is adequate."[128] If the value of a company's shares does not exceed par, the company (before the issue of new stock) reduces the par value of its shares so that the new issue can be disposed of at par.[129] As has already been indicated, majority shareholders sometimes deliberately issue new shares at a time when they think a minority shareholder cannot raise sufficient funds to exercise his pre-emptive right. They may couple this careful timing of the issue with a short time limit for the exercise of the pre-emptive right.

On the whole, the courts have been surprisingly reluctant to prevent the dilution of a minority shareholder's interest through the issuance of new stock to majority shareholders at an inadequate price or at a time when the minority shareholder is unable to buy his proportionate part of the new issue.[130] This reluctance to grant relief to minority shareholders has been explained as being based partly on the "general judicial policy of refusing to interfere in the internal affairs of a corporation."[131]

In *Bellows* v. *Porter*[132] the majority shareholder caused the issuance of new shares at a time when the minority shareholder was unable to purchase. Upon failure of the minority to exercise its preemptive rights, all the new shares were issued to the majority shareholder to satisfy a claim he had against the corporation. The minority shareholder brought suit claiming that the real purpose of the issuance was to dilute his interest and lower the book value of his shares. The court, however, denied relief, holding that the stock was properly issued.

[127] See Nash v. Lancegaye Safety Glass (Ireland), Ltd., 92 Ir. L.T.R. 11, 23 (1956).

[128] O'Neal, Close Corporations: Law and Practice § 8.09 (1958).

[129] See Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122, 123 (1951).

[130] Bellows v. Porter, 201 F.2d 429 (8th Cir. 1953); Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951); Schramme v. Cowin, 205 App. Div. 20, 199 N.Y. Supp. 98 (1st Dep't 1923).

[131] O'Neal, Close Corporations: Law and Practice § 8.09 (1958). See also Note, 35 N.C.L. Rev. 271, 277 (1957).

[132] 201 F.2d 429 (8th Cir. 1953).

Impecunity of the minority shareholder alone and his resulting inability to buy his proportionate part of a new issue is usually not enough to cause a court to grant relief. The attitude of some judges on this question is shown by the recent case of *Maguire* v. *Osborne*.[133] There a minority shareholder sought to prevent the issuance of a new block of stock on the grounds that the stock was being purposely issued at a grossly inadequate price at a time when he could not purchase his proportionate part. The court, in refusing to grant relief, remarked:

> The fixing of the value of the new stock at par with the offer of pre-emptive rights gave to all of the stockholders, including the plaintiff, the right to purchase the newly issued stock at the same price as that of the original issue. The fact that plaintiff is financially unable to purchase the newly issued stock is *unfortunate* but it is to be observed that the fixing of the value . . . at a higher price would be no solution to her predicament.[134]

Some courts seem to believe that the impecunious minority shareholder's predicament is not a particularly serious one. They suggest that he can sell his pre-emptive right or borrow to purchase the new shares, using the shares to be acquired as security for the loan.[135] This suggestion, however, overlooks the facts that seldom can anyone be found who will pay for the right to buy a minority interest in a close corporation, especially one wracked by dissension, and that banks are not likely to consider a minority interest in such a corporation good security for a loan.

Even assuming a minority shareholder can raise funds to buy his proportionate part of a new issue of shares, it may still be unfair to force him to make further investments in the company in order to preserve his existing interest. If the company's earnings have been used to pay handsome salaries to majority shareholder employees and if the minority shareholder has received little or nothing in the way of dividends, naturally he will be very reluctant

[133] 388 Pa. 121, 130 A.2d 157 (1957).

[134] *Id.*, at 388 Pa. 124, 130 A.2d 159. Cf. Bodell v. General Gas & Electric Corp. 15 Del. Ch. 420, 140 Atl. 264 (Sup. Ct. 1927) where plaintiffs, who had used their dividends to purchase stock shortly before additional stock was made available at a very low price to stockholders to the extent of their dividends, were denied relief in their efforts to enjoin the stock sale. The court found no fraud or improper motives.

[135] Bellows v. Porter, 201 F.2d 429, 433-34 (8th Cir. 1953), Schramme v. Cowin, 205 App. Div. 20, 199 N.Y. Supp. 98, 100 (1st Dep't 1923). For a case recognizing that these supposed alternatives are unrealistic, see Steven v. Hale-Haas Corp., 249 Wis. 205, 23 N.W.2d 620 (1946).

to send good money after bad by investing additional capital in the business. Yet even under these circumstances, most courts will probably sustain a new issue of shares if a plausible case can be made that the corporation needs additional capital.

On the other hand, courts will invalidate stock issues if they are convinced the directors in issuing the stock acted against the best interests of the corporation or for "selfish motives."[136] The courts recognize that the directors are subject to fiduciary duties in issuing new stock, and they consistently hold that the directors breach such fiduciary duties when they issue new shares to themselves in order to gain control of the corporation or to perpetuate control.[137]

A number of decisions within the last ten years, proceeding on the theory that directors and controlling shareholders are subject to fiduciary duties to minority shareholders, have granted relief to minority shareholders against dilution of their interests through the issuance of additional shares. One of the leading cases is *Gaines* v. *Long Mfg. Co.*[138] In that case, a minority shareholder sought to enjoin a new issue of stock proposed by the majority, alleging that the corporation did not need additional capital, that it had prospered from the start, that the sole purpose of the plan was to reduce the value of plaintiff's stock, and that the plan would in fact reduce the value of plaintiff's stock from $60,000 to $800. The court held that the complaint stated a cause of action for equitable relief. It pointed

[136] The test for such a breach is phrased quite strictly by some courts, however. In Gamble v. Queens County Water Co., 123 N.Y. 91, 98, 25 N.E. 201, 202 (1890), the court noted that the action "must be so detrimental to the interests of the corporation itself as to lead to the necessary inference that the interests of the majority of the shareholders lie wholly outside of and in opposition to the interests of the corporation, and of the minority of the shareholders, and that their action is a wanton or fraudulent destruction of the rights of the minority." This test is criticized for ignoring "the possibility that the interest of the minority in the corporation might be destroyed without damaging the corporation." See Note, 35 N.C.L. Rev. 271, 277 (1957).

In a series of cases—Floor v. Johnson, 199 P.2d 547 (Utah 1948); State ex rel. Kahn v. Johnson, 199 P.2d 556 (Utah 1948); New Quincy Mining Co. v. Johnson, 199 P.2d 561 (Utah 1948)—the court allowed cancellation of 200,000 shares of stock issued within five days of the annual meeting of shareholders of a public issue corporation. The shares ostensibly were issued as consideration for certain contracts, but through a specious trust arrangement they in fact were retained by a faction seeking to maintain control of the corporation. The court found fraud in the issuance of the shares.

[137] Schwab v. Schwab-Wilson Mach. Co., 13 Cal. App. 2d 1, 55 P.2d 1268 (1936); Canada Southern Oils, Ltd. v. Manabi Exploration Co., 33 Del. Ch. 537, 96 A.2d 810 (1953). A similar holding will obtain where treasury stock is involved. See Anderson v. Albert & J. M. Anderson Mfg. Co., 90 N.E.2d 541 (Mass. 1950).

[138] 234 N.C. 340, 67 S.E.2d 350 (1951).

out that, although directors and majority shareholders have the right to control the corporation, they are subject to fiduciary duties to minority shareholders in exercising their powers.

At least one court has exhibited an attitude even more favorable to the aggrieved minority shareholder. In *Bennett* v. *Breuil Petroleum Corp.*[139] the Delaware Chancery Court stated that it would grant relief whenever the main purpose of the issuance was to "squeeze" the minority or where the shares were offered for a grossly inadequate consideration.[140]

A stock option or executive stock purchase plan can be utilized to get additional shares into the hands of majority shareholders.[141] Under such an incentive arrangement, the privilege to purchase the lion's part of the shares is usually given to executives and other key personnel. As majority shareholders generally occupy the executive positions in the company and as minority shareholders often do not have jobs with the company, an incentive plan will frequently operate to dilute minority holdings.[142]

A group of shareholders can also increase their proportionate control and interest in a corporation by causing it to declare stock dividends. Suppose, for instance, that the group of shareholders in control of Corporation X holds all of its Class B stock but that substantial amounts of its Class A stock are held by outsiders. The controlling group might cause the corporation to declare a dividend in Class A stock on the Class B stock. The result of this would be dilution of the outsiders' interests in the business. Most states allow a stock dividend in one class of stock to be declared on another class

[139] 99 A.2d 236 (Del. Ch. 1953).

[140] Responding to the contention that the plaintiff-minority shareholder in this case could not complain of dilution of his holdings by a new stock issue, since he had been offered his pro rata share of the issue, the court observed that the plaintiff had "the right not to purchase as well as the right to purchase. But his right not to purchase is seriously impaired if the stock is worth substantially more than its issuing price. . . . A corporation is not permitted to sell its stock for a legally inadequate price, at least where there is objection. Plaintiff has a right to insist upon compliance with the law whether or not he cares to exercise his option." 99 A.2d at 240-41.

[141] In Schwartz v. Miner, 146 A.2d 801 (Del. Ch. 1958), the court considered a stock option plan involving as optionees two directors and eleven department heads, who could purchase stock at 95 per cent of market value. The optionees were required to sign a two-year employment agreement. While recognizing "that a stock option plan might conceivably be created for the purpose of preserving control," the court found that optionees were "not in control of the corporation or in working control of the stock" and that the plaintiff had only shown "that the optionees exercised admittedly valuable rights." *Id.*, at 805.

[142] Chancellor Collins J. Seitz of Delaware has suggested that in a small corporation, "the executive stock option plan can well be used to accomplish an inequitable objective." Letter from Collins J. Seitz, dated Jan. 18, 1960.

of stock,[143] and even where a dividend is not expressly provided for by statute, a charter provision authorizing it probably is valid. Only a few states protect existing holders of the class of shares being issued as a stock dividend by requiring that the directors obtain approval of classes of shares adversely affected.[144] In the absence of such a statutory safeguard, aggrieved shareholders have to establish a breach of fiduciary duty by the directors in order to get relief against a stock dividend.

[143] See, e.g., Ohio Rev. Code Ann. § 1701.33 (Page Supp. 1958); Va. Code Ann. § 13.1-43 (1956); Wis. Stat. § 180.38 (1955).

[144] For a statute giving such protection, see N.C. Gen. Stat. § 55-51 (Supp. 1959).

Chapter v. SQUEEZE-OUT TECHNIQUES: CONTRACTUAL ARRANGEMENTS, APPROPRIATION OF BUSINESS OPPORTUNITIES, AND MISCELLANEOUS

§ 5.01. *Scope of chapter*

This chapter discusses a heterogeneous lot of squeeze-out techniques. It first sets forth some of the contractual arrangements which controlling shareholders can use to siphon off corporate earnings, e.g., management contracts and leases of property to the corporation at exorbitant rentals. It then discusses ways in

which controlling shareholders can appropriate corporate assets or opportunities or split off for themselves a part of the company's business.

Attention is also given to squeeze-out techniques which are available in rather special situations. For example, consideration is given to ways in which stock transfer restrictions can be manipulated to frustrate the expectations of some of the participants, and to the rather rare situations in which minority shareholders can squeeze out or coerce majority shareholders. And a section is devoted to speculation on squeeze-play possibilities in the new "tax option" corporations introduced by Subchapter S of the Internal Revenue Code.

A considerable amount of space is allotted to the withholding of information on corporate affairs, a sort of ancillary squeeze technique that is resorted to in almost all squeeze-plays. Finally, a section is devoted to the expanding conception of fiduciary duties which directors and controlling shareholders owe to minority shareholders, since a squeeze-play almost invariably raises questions on the nature or scope of such duties.

§ 5.02. *Siphoning off earnings by favorable leases, loans without interest, and other contractual arrangements*

Contracts of various kinds between a corporation and its majority shareholders or business units they own—contracts not arrived at by arm's length bargaining—can be used to siphon off corporate assets. For example, majority shareholders sometimes drain off corporate earnings by leasing property to the corporation at an exorbitant rent. Conversely, they may lease property from the corporation at an inadequate rental.[1]

Even in a small business, controlling shareholders sometimes enter into a management contract[2] or a consulting contract[3] with the corporation under which it pays them (or another business they

[1] See Brilliant v. Long Island Waste Co., 192 N.Y.S.2d 797 (Sup. Ct. 1959) (allegation that director-officers leased corporate property to tenants at insufficient rentals and that director-officers were financially interested in the tenants who received the benefit of the leases).

[2] See, e.g., Robb v. Eastgate Hotel, 347 Ill. App. 261, 106 N.E.2d 848 (1952).

[3] See Koster v. Warren, 176 F. Supp. 459 (N.D. Calif., S.D., 1959).

own) sizable sums for rendering management or consulting services. Or the contract may take the form of a so-called "exclusive dealing" agreement, under which the corporation agrees to purchase all of its supplies from the controlling shareholders or to sell all of its products to them.

An interesting California case[4] suggests a new wrinkle in the use of a contract to drain off corporate earnings for the benefit of majority shareholders. In that case, the shares of Midway were held as follows: 37½ per cent by Beigel, 37½ per cent by Snyder, and 25 per cent by Lopez. Beigel and Snyder along with Beigel's son-in-law, Sill, were partners in a firm, Universal Supply Company. A contract was executed under which Snyder exchanged his interest in Universal for Beigel's interest in Midway—thus giving Snyder 75 per cent of Midway—and Midway agreed to furnish plumbing supplies to Universal at stipulated prices.[5]

Despite Beigel's disposition of his interest in Midway, he continued to serve as its president. In a suit by Midway against Beigel and Sill to recover secret profits arising out of the agreement, plaintiff introduced evidence tending to show that the prices defendants were paying under the contract were substantially lower than the prices charged other customers. Thus, viewed realistically, Midway's undertaking to supply Universal on favorable terms was part of the price Snyder gave for Beigel's interest in Midway. The litigants have twice taken this case to the California District Court of Appeal; but this litigation still appears to be far from concluded.[6]

A minority shareholder can usually relieve the company from an unfair lease or other contract by bringing a derivative action on its behalf to void the lease or contract. A transaction between a corporation and its directors or shareholders is clearly voidable at the option of the corporation if the transaction is unfair to it.[7] In many

[4] Tevis v. Beigel, 156 Cal. App.2d 8, 319 P.2d 98 (1957); 174 Cal. App.2d 90, 344 P.2d 360 (1959).

[5] The earlier opinion in Tevis v. Beigel, *supra*, n. 4, states that Beigel and Sill, doing business as Universal Supply Company, entered into a written contract with Midway for the sale of plumbing supplies by Midway to Beigel and Sill. 156 Cal. App.2d at 13, 319 P.2d at 99-100. The later opinion states that it appeared from the terms of the agreement that Snyder exchanged his interest in Universal for Beigel's interest in Midway. 344 P.2d at 362. Query whether Snyder signed the agreement. Apparently Lopez was not a party to it.

[6] In the later opinion, the appellate court reversed the trial judge, holding that he erred in rejecting defendants' offer to prove that the sales by Midway were made with the full knowledge and acquiescence of Snyder and Lopez, who controlled Midway and owned all its stock. 174 Cal. App.2d 90, 344 P.2d 360 (1959).

[7] See Lattin, Corporations § 12 (1959); Stevens, Corporations § 148 (2d ed. 1949).

jurisdictions a contract or transaction which is not authorized on behalf of the corporation by a disinterested quorum and majority of directors is voidable by the corporation even in the absence of a showing of unfairness.[8]

Furthermore, the corporation can recover any secret profits that a director or controlling shareholder has derived from a transaction with it. Thus, in a Massachusetts case,[9] a corporate director who had organized another business to purchase gasoline for resale to the corporation and had marked up the gasoline with resulting profit to himself, was held liable to account to the corporation for profits made on the sales.

Minority shareholders quite often complain that the corporation is making loans to officers or majority shareholders without interest and with little or no security.[10] In a North Carolina case[11] a large shareholder, who was also secretary-treasurer of the corporation, purchased from it a piece of land for $2,000, giving four notes of $500 each. Minority shareholders claimed that neither the notes nor the interest had been paid by the purchaser or demanded by the corporation.

In family corporations it is sometimes the practice for the corporation to lend money to shareholders or members of their families without interest.[12] If there are minority shareholders who do not enjoy the privilege of borrowing from the corporation on favorable terms, they are of course quite likely to object to the corporation's making large interest-free or unsecured loans to majority shareholders or their relatives.

As a Massachusetts court has pointed out, even in a family corporation which in the past has commonly made interest-free loans

[8] For a discussion of the rules applicable to transactions between a corporation and its directors, see Lattin, Corporations § 12 (1959).

[9] Durfee v. Durfee & Canning, Inc. 323 Mass. 187, 80 N.E.2d 522 (1948).

[10] See, e.g., Mitchell v. Aulander Realty Co., 169 N.C. 516, 86 S.E. 358 (1915); Felsenheld v. Bloch Bros. Tobacco Co., 119 W. Va. 167, 192 S.E. 545 (1937) (plaintiff alleged that soon after the election of Bloch as president the corporation began a practice of extensive and repeated loans of funds to members of the Bloch family without security and at less than the legal rate of interest and that many of the loans were still unpaid).

[11] Mitchell v. Aulander Realty Co., 169 N.C. 516, 86 S.E. 358 (1915).

[12] Perry v. Perry, 160 N.E.2d 97 (Mass. 1959). In Holden v. Lashley-Cox Land Co., 316 Mich. 478, 25 N.W.2d 590 (1947), a shareholder-officer occupied without rental a house owned by the corporation which was later sold to another shareholder for less than the corporation originally paid and for substantially less than market value. A third shareholder, the husband of the purchaser, charged the corporation a 5 per cent sales commission and a 5 per cent collection fee for selling the house to his wife.

to shareholder-officers, "no basis appears for the corporation to forego interest on loans to officers which were outstanding for any substantial period and were not made for the benefit of the corporation";[13] and nonconsenting shareholders can obtain relief if they attack the arrangement seasonably.

In a West Virginia case[14] a nonconsenting shareholder brought a derivative action against controlling shareholders, alleging that the latter had caused extensive and repeated loans of corporate funds to be made to themselves without security and at less than the legal rate of interest, and that many of the loans were still unpaid. Plaintiff asked for an accounting and prayed that all canceled loans on which no interest had been paid be reopened in order to charge 6 per cent interest; that defendants be required to pay 6 per cent interest on loans still open; and that defendants be perpetually enjoined from making any additional loans of corporate funds to any officer, director, or shareholder. The court refused to enjoin future loans but granted the other relief requested.

Sometimes controlling shareholders cause a corporation to make loans under circumstances indicating their awareness that repayment is unlikely. In one such case,[15] Corporation A loaned $20,000 to Corporation B, a financially embarrassed company controlled by one of A's principal shareholders. B proceeded to lend some of this money to another of A's principal shareholders. In this case, the court held that the loan was *ultra vires,* i.e., outside the corporation's powers, and therefore invalid.

On rare occasions majority shareholders with funds to invest have caused the corporation to borrow from them at the maximum legal rate or other favorable interest rate even though the corporation was not in need of a loan. This occurred in a Delaware case.[16] There Kenealy, the corporation's principal shareholder and chief executive officer, caused the corporation to borrow $8,000 from his father's estate. The estate was kept open for a protracted period. Although the loan was technically made on behalf of the estate, actually it was made for the benefit of Kenealy, who was executor and sole beneficiary. Kenealy claimed that the loan was made at 6 per cent interest,

[13] Perry v. Perry, 160 N.E.2d 97, 105 (Mass. 1959).
[14] Felsenheld v. Bloch Bros. Tobacco Co., 119 W. Va. 167, 192 S.E. 545 (1937).
[15] Riley v. Callahan Mining Co., 28 Idaho 525, 155 Pac. 665 (1916).
[16] See Tansey v. Oil Producing Royalties, 133 A.2d 141 (Del. Ch. 1957).

but it appeared that at various times a much higher interest was paid.

A minority shareholder brought suit to require Kenealy to account to the corporation for the interest it had paid the estate over the years. The court concluded that the loan was "no more than an attempt by the defendant [Kenealy] to obtain continuing interest payments for his personal purposes";[17] and that Kenealy, having handled the entire transaction for the corporation and having in effect dealt with himself, must account to the corporation for all interest paid.

§ 5.03. *Siphoning off profits by having other enterprises perform services for corporation*

Sometimes majority shareholders contrive to have work performed for the corporation by other enterprises they control. In a Florida case[18] Deeb acquired a substantial stock interest in a corporation whose assets consisted of a building and the land on which it was situated.

> At this time the corporation was not indebted and the rent from the property was sufficient to pay the carrying charges, taxes, and a fair dividend to the stockholders. Immediately after Deeb acquired the majority of stock and had installed his personal attorney and secretary as directors [who then proceeded to elect themselves to office]. . . , he conceived a scheme of spending large sums of money through his construction company in remodeling said building and, without having any definite plans or making any financial arrangements he began to lay out and expend large sums of money in the improvement of a frame building which was erected in 1896. The lot . . . was worth from $30,000 to $40,000 and the building . . . about $10,000. [He] spent in excess of $24,000 and encumbered the real estate with a mortgage for the sum of $20,000.[19]

Construction supplies were purchased by Deeb's construction company from Deeb's building supply company. Part of the salary of the construction company's secretarial help was provided by the corporation. Various other Deeb-controlled companies were also involved in the work performed on the building.

[17] 133 A.2d at 143-44.
[18] Finn Bondholders v. Dukes, 26 So.2d 802 (Fla. 1946).
[19] Brief for Petitioner, pp. 3-4, Finn Bondholders v. Dukes, 26 So.2d 802 (Fla. 1946).

In a New Jersey case[20] the corporation operated a mail order business under the guise of a "Club." Plaintiff owned 30 per cent of the stock; the two defendants together owned the other 70 per cent. The principal defendant also owned two other companies—Products, Inc. and Distributors, Inc., conducted individually another related enterprise, and with his family and the other defendant's wife operated still another company, Automatic Mailing Service, Inc. It was charged that

> All of the administrative functions of the Club in the United States (processing and servicing) have, notwithstanding objections by the plaintiff, been performed for the Club by the various companies owned and operated by [principal defendant]. In fact, the Club is but a shell of an organization. Practically all the people who perform its work are on the payroll of . . . Products; its supplies are purchased through . . . Products; its mailing service was originally performed by outside contractors but has been taken over by Automatic Mailing Service. The . . . companies and Automatic Mailing Service bill the Club for these various services and supplies.[21]

Though stating that the amounts to be charged the Club were "allocated" to it, defendants "specifically admitted that no records are kept from which these allocations could be supported."[22] Over a four-year period approximately $1,000,000 passed from the Club to the principal defendant or to companies owned or controlled by him.

§ 5.04. *Splitting off part of business and transferring it to majority shareholders*

Majority shareholders sometimes can obtain an inequitable share of the earnings of an enterprise and thus decrease distributions to other participants by splitting off profitable components of the enterprise and acquiring those components for themselves. A member of one of the nation's leading law firms writes as follows:

> An unusual instance came to our attention some months ago where the majority stockholders of a corporation "split off" certain of the business functions, including sales, the manufacture of components, etc.

[20] Roach v. Margulies, 42 N.J. Super. 243, 126 A.2d 45 (1956).

[21] Brief for Plaintiff-Respondent, p. 5, Roach v. Margulies, 42 N.J. Super. 243, 126 A.2d 45 (1956). This case also discussed §§ 5.13, 8.09, *infra*.

[22] *Id.* at p. 6.

Separate corporations, owned completely by these majority stockholders were formed to handle each of these functions. By appropriate pricing policies, matters were so arranged that most of the profits were channeled into these new corporate entities.[23]

In another case,[24] property and good will of the sales department of an operating company were turned over to a separate sales company owned by defendants, majority shareholders of the operating company. This transaction occurred without consideration, corporate action, or notice to minority shareholders. The sales company performed all the selling for the operating company as well as for several other corporations controlled by defendants.

§ 5.05. *Appropriation of corporate assets, contracts, or credit and use for personal purposes*

Controlling shareholders sometimes crudely appropriate corporate funds or assets and use them for personal purposes. For example, in one case[25] controlling shareholders used corporate funds to speculate on the securities market; in another case[26] shareholders in control used about $200,000 of the corporation's money to pay for labor and services in constructing a building owned by another company. Perhaps the most common technique for appropriating corporate assets is inflation of expense accounts by shareholder-officers.[27]

Sometimes the appropriation of corporate assets is something less than fraudulent. For instance, early in the history of one family corporation, the practice was commenced of compensating one of the boys in the family for errands and other small tasks by permitting him to sell the company's scrap assets, then trivial in amount; when the boy reached adulthood, he continued

[23] The attorney's name is withheld to preserve anonymity of parties involved. Letter from him dated September 11, 1959, is on file in Small Business Research Studies Office, Duke University School of Law.

[24] Chounie v. Laing, 125 W. Va. 275, 23 S.E.2d 628 (1942). Cf. Remilliard Brick Co. v. Remilliard Dandini Co., 109 Cal. App.2d 405, 241 P.2d 66 (1952); Rosenblum v. Judson Engr. Corp., 99 N.H. 267, 109 A.2d 558 (1954).

[25] Felsenheld v. Bloch Bros. Tobacco Co., 119 W. Va. 167, 192 S.E. 545 (1937).

[26] See West View Hills, Inc. v. Lizau Realty Corp., 6 N.Y.2d 344, 160 N.E.2d 622 (1959).

[27] See, e.g., Brilliant v. Long Island Waste Co., 192 N.Y.S.2d 797 (Sup. Ct. 1959) (plaintiff charged that defendants had not only diverted corporate funds by 500 per-cent salary increases to themselves but had also taken excessive amounts of corporate money for alleged expenses).

to sell the scrap, realizing returns of over $11,000 a year.[28] The sale of the scrap had never been authorized by the board of directors.

In contrast are those situations in which majority shareholders physically appropriate the capital assets of the corporation for use in another enterprise which they own or control.[29] In one such case[30] defendants, majority shareholders, took all the company's assets from its place of business, transported them to another town, and used them to establish a partnership to operate a similar type of business. Twelve years later defendants, acting as majority shareholders of the original corporation, executed a conveyance of the corporate assets to the partnership.[31] In another case[32] majority shareholders in a family corporation formed a new company and utilized all of the old corporation's assets to develop the new company for themselves.

Occasionally participants in a business are able to appropriate the company's contracts to their own use. In one such case,[33] plaintiff, anticipating the end of prohibition, conceived the idea of obtaining exclusive agencies from foreign manufacturers of wine and liquors, and of importing, selling, and distributing those products. He associated defendant, an importer, with him in a joint enterprise to be carried on in plaintiff's name. Plaintiff supplied funds and credit; defendant was the manager. The agencies were obtained, the principal ones being terminable by the manufacturers on thirty and ninety days respectively. Soon after the establishment of this joint venture, defendant

> [D]eliberately and in bad faith conceived, formulated and continuously engaged in a course of conduct, both secretive and otherwise, for the purpose of acquiring and appropriating to himself the said exclusive agencies and of depriving the said joint enterprise . . . of . . . [the] exclusive agencies and eliminating plaintiff from said business. . . . [D]efendant . . . continuously resorted to disparagements, pressure, conniving

[28] Santarelli v. Katz, 270 F.2d 763 (7th Cir. 1959).

[29] See, e.g., Thompson v. Thompson, 214 S.C. 61, 51 S.E.2d 169 (1948); Laurel Springs Land Co. v. Fougeray, 50 N.J.Eq. 756, 26 Atl. 886 (1893); Carr v. Carr O'Brien 386 Pa. 196, 125 A.2d 607 (1956). See also Mardel Securities, Inc. v. Alexandrea Gazette Corp. 183 F. Supp. 7 (E.D. Va. 1960) (majority shareholder's newspaper printed at corporation's plant for inadequate price).

[30] Walden v. Walden, 268 Ala. 145, 105 So.2d 105 (1958) (relief barred by laches). For a similar factual situation, see Peoples v. Southern Chemical Corp., 194 Ga. 388, 21 S.E.2d 698 (1942). See also Brown v. Dolese, 154 A.2d 233 (Del. Ch. 1959).

[31] See also Laurel Springs Land Co. v. Fougeray, 50 N.J.Eq. 756, 26 Atl. 886 (1893) (corporate assets and property conveyed to another company).

[32] Samia v. Central Oil Company of Worcester, 158 N.E.2d 469 (Mass. 1959).

[33] Elsbach v. Mulligan, 58 Cal. App.2d 354, 136 P.2d 651 (1943).

> and misrepresentations for the purpose of forcing plaintiff to give up his interest in the business and for the purpose of persuading and inducing the said manufacturers . . . to terminate and cancel the . . . agencies, and to grant said agencies to defendant . . . personally.[34]

As a direct result of the defendant's actions, the venture's agencies were withdrawn and agencies were issued to defendant.

Majority shareholders may also pledge a corporation's credit for their own obligations or the obligations of businesses in which they are interested.[35] Thus, in a Delaware case[36] the court concluded that corporate credit had been used to a large extent by the controlling shareholder "to safeguard prior investments made by him personally or made by him on behalf of 'his' Building and Loan Association." In this same case the controlling shareholder, after personally extending credit in large amounts to one Roberts, caused the corporation to make loans to Roberts after the latter's credit sources had dried up; the controlling shareholder testified that he used the company "in order to prevent his wife from knowing that he was advancing more money to Roberts."[37]

An obvious remedy that minority shareholders have whenever majority shareholders appropriate corporate assets is a derivative action to recover for the corporation the assets which have been wrongfully appropriated. If the corporation's property has been fraudulently conveyed to another business organization, the conveyance will be set aside.[38]

Recovery of funds or assets which have been misappropriated, however, might not be a complete or final remedy if the very management which dissipated the assets remains in control of the corporation. Thus it may be advisable, to the extent permissible under local rules of procedure and practice, to couple the derivative action with an action for the appointment of a receiver to wind up the corporation's affairs.[39] Some courts have held that in the absence of statute an equity court does not have authority to wind up the affairs of a corporation, except possibly where the object of the corporation has become impossible of attainment, and that con-

[34] *Id.* at 360-61, 136 P.2d at 655.

[35] See People's Investment Co. v. Crawford, 45 S.W. 738 (Tex. Civ. App. 1898).

[36] Tansey v. Oil Producing Royalties, 133 A.2d 141, 146 (Del. Ch. 1957).

[37] 133 A.2d at 145.

[38] See Laurel Springs Land Co. v. Fougeray, 50 N.J.Eq. 756, 26 Atl. 886 (1893).

[39] See Goodliffe v. Colonial Corp., 107 Utah 488, 155 P.2d 177 (1945) (minority shareholder bringing derivative action requested in connection therewith an accounting and appointment of a receiver).

sequently equity has no authority to appoint a receiver at the suit of a shareholder to wind up the corporation.[40] This view was expressed by a Texas court in the following language:

> Courts of equity, by virtue of their general equitable jurisdiction, will not appoint a receiver of a corporation, and assume control and management of its affairs, at the suit of a stockholder alleging fraud, mismanagement, and collusion on the part of the corporate authorities, or ultra vires acts of the directors or of the corporation itself, but in such cases will limit the redress granted to the specific wrongs charged, and will go no further than to enjoin or forbid the misconduct complained of.[41]

Many courts, however, even in the absence of statute, will appoint a receiver and wind up a corporation if the directors or officers have been guilty of fraud, have abused and oppressed minority shareholders, or have grossly mismanaged the corporation.[42] Furthermore, many corporation statutes expressly empower the courts to appoint a receiver and wind up a corporation if groups controlling the corporation are guilty of fraudulent conduct or are wasting corporate assets, or if winding up is necessary to protect the rights of shareholders.[43]

[40] Taylor v. Decatur Mineral & Land Co., 112 Fed. 449 (N.D. Ala. 1901); People *ex rel.* Daniels v. District Ct. of Denver, 33 Colo. 293, 80 Pac. 908 (1905); Tampa Waterworks Co. v. Wood, 97 Fla. 493, 121 So. 789 (1929).

[41] People's Inv. Co. v. Crawford, 45 S.W. 738, 740 (Tex. Civ. App. 1898).

[42] Ashton v. Penfield, 233 Mo. 391, 135 S.W. 938 (1911) (majority shareholders knowingly kept fraudulent general manager in charge of the corporation's affairs); Lennan v. Blakely, 273 App. Div. 767, 75 N.Y.S.2d 331 (1947); Patton v. Nicholas, 154 Tex. 385, 279 S.W.2d 848 (1955) (in more extreme cases of abuse of minority shareholders' rights, a court may decree liquidation and appoint a receiver for that purpose or it may appoint a receiver for the less drastic purpose of rehabilitation). See Hornstein, A Remedy for Corporate Abuse—Judicial Power to Wind Up a Corporation at the Suit of a Minority Stockholder, 40 Colum. L. Rev. 220 (1940). See also Hornstein, Stockholders' Agreements in the Closely Held Corporation, 59 Yale L.J. 1040, 1046-47 (1950), pointing out that Section 9 of the New York Stock Corporation Law recognizes the general equity power of courts to dissolve a corporation by providing that nothing in that section "shall be construed to limit the power of a court of equity to decree a dissolution in a proper case."

"In recent years courts of equity have often recognized their inherent right to wind up the affairs of a solvent going corporation and to appoint a receiver for that purpose for the protection of minority stockholders when fraud and gross mismanagement by corporate officers, causing the real imminent danger of great loss, clearly appears, and cannot be otherwise prevented." Drob v. National Memorial Park, Inc., 28 Del. Ch. 254, 41 A.2d 589, 597 (1945).

[43] See, e.g., Cal. Corp. Code § 4651 (e) (Deering 1955); Conn. Gen. Stat. § 33-115 (Rev. 1958); Ill. Ann. Stat. Ch. 32 § 157.86 (a) (3) (4) (Smith-Hurd 1954); La. Rev. Stat. tit. 12, § 752 (2) (11), 753 (b) (1950); Me. Rev. Stat. Ch. 53 §§ 104, 105 (1954); Minn. Stat. Ann. §§ 301.49 (3), 301.50 (1), 301.51 (1945); Mo. Ann. Stat. §§ 351.485 (1) (b) (c), 351.490 (1) (Vernon 1952); Nev. Rev. Stat. § 78.650 (1957); N.D. Rev. Code §§ 10-2116 (1) (b) (d), 10-2117 (Supp. 1957); Ore. Rev. Stat. 57.595 (1) (a) (B) (D) (Rev. 1959); Pa. Stat. Ann. tit. 15, § 2852-1107 (1938); R.I. Gen. Laws Ann. 7-5-17 (1956); Tex. Bus. Corp. Act, art. 7.05 (A) (1) (c) (d) (1956); Va. Code Ann. §§ 13.1-94 (a) (2) (4), 13.1-95 (1950); Wis. Stat. § 180.771 (1) (a) (2) (3) (1957). See also, Model Business Corporation Act, § 90 (a) (2) (4) (Rev. 1953).

§ 5.06. *Usurping corporate opportunities*

Not uncommonly a shareholder who is a director or officer seizes for himself a business opportunity which might benefit his corporation.[44] Thus, in a recent case,[45] two members of a company's board, Zahniser and Smith, were selected to investigate the potentialities of a contract to manufacture land mines for the U. S. Army. Upon completing a summary investigation, they reported to the board that for the corporation to participate it would have to remodel extensively, add more space and labor, and put into operation a complicated assembly procedure. On their recommendation, the board concluded that it would be unwise for the company to participate in the project.

Several days later, Zahniser and two friends began to organize a new corporation to manufacture land mines. They submitted a bid to the government in the name of the corporation being organized, but the bid was turned down because the corporation was not yet a legal entity. A partnership was then formed in which Zahniser and his friends were full partners and Smith a limited partner. The firm obtained two lucrative contracts with the government, on which it made a net profit of $180,000. The corporation, which had been given subcontracts by the partnership, made a profit of nearly $250,000.

A shareholder in the original corporation brought a derivative suit to recover for the corporation the profits which had been diverted from it to the partnership. Finding that bad faith permeated the entire scheme, the court granted the relief requested. The court stated that the actions of the director-partners, "while short of fraud or deceit, were in calculated indifference to the corporate common good."[46] The director-partners were held to have breached their fiduciary duty to the corporation in not recommending corporate participation in a contract which could easily have been ful-

[44] See generally Carrington and McElroy, The Doctrine of Corporate Opportunity as Applied to Officers, Directors, and Stockholders of Corporations, 14 Bus.Law. 957 (1959) (an exhaustive list and discussion of the cases in this area); Lattin, Corporations 250-257 (1959).

A similar rule may obtain where majority shareholders are in a position of control similar to directors and usurp corporate opportunities. See Carrington and McElroy, *supra,* at 966-967.

[45] Higgins v. Shenango Pottery Co., 279 F.2d 46 (3d Cir. 1960).

[46] *Id.* at 52.

filled, as evidenced by the fact that an "embryo organization,"[47] as the court termed the partnership, solved the problem of participation. Defendants pointed out that the corporation had also made a profit from the contracts, but the court rightly held that "leaving behind a portion of the spoils is hardly justification."[48]

Corporate opportunities are also quite often appropriated through acquisition of property in which the corporation has an existing or expectant interest. In one Florida case,[49] for example, defendant, a majority shareholder and officer, purchased two parcels of property which had been used by the corporation in its business. Defendant exacted a rental charge for one piece of property on which the corporation had not previously paid rent, and increased the rental on the other piece. The court held that defendant had breached his fiduciary duty to the corporation and decreed that he held the property in constructive trust for the corporation.[50] Although the corporation did not have the cash necessary for the purchase, the court noted that it could have purchased the property, financing its purchases in the same way the defendant had.

There are, of course, limitations on the corporate opportunity doctrine. Borderline cases frequently arise. Thus, in the well-known case of *Lincoln Stores* v. *Grant*,[51] two directors and an important employee of plaintiff corporation, intending to carry on a business similar to plaintiff's, secretly purchased the stock of a non-competing corporation whose store was located within ninety feet of plaintiff's store. They used confidential information obtained through plaintiff to determine inventory and capital needs of the new enterprise. When the loyal members of plaintiff's management discovered that the two directors were co-owners of this competing business—the new enterprise was being managed by the former employee—they caused plaintiff to bring an action seeking an injunction

[47] See also Higgins v. Shenango Pottery Co., 256 F.2d 504 (3d Cir. 1958); 1 CCH Corp. Law Guide § 385 (1960).

[48] 279 F.2d 46, 49.

[49] News-Journal Corp. v. Gore, 147 Fla. 217, 2 So.2d 741 (1941). Compare the following joint venture and partnership cases: Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928); Bakalis v. Bressler, 1 Ill.2d 72, 115 N.E.2d 323 (1953); Boxill v. Boxill, 111 N.Y.S.2d 33 (Sup. Ct. 1952).

[50] If there has been a bona fide, but unsuccessful, effort to find finances for the corporation, the directors or officers may have much more freedom in the "opportunities" they undertake. See, e.g., Zeckendorf v. Steinfield, 12 Ariz. 245, 100 Pac. 784 (1909), modified 225 U.S. 445 (1912).

[51] 309 Mass. 417, 34 N.E.2d 704 (1941); see also Fuller, Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors, 26 Wash. U.L.Q. 189 (1941).

against the former employee and the two directors to stop them from operating the competing business. Plaintiff also sought an accounting for damages and a declaration that the three defendants held the shares they had bought in constructive trust for plaintiff.

The court distinguished between the acquisition of the business by the defendants and their operation of it. Noting the "absence of any interest, express or implied, on the part of the company in the acquisition of this store,"[52] the court held that defendants had breached no duty in acquiring the shares in the other company and that no constructive trust would arise. However, the court indicated that plaintiff's directors were under a duty not to compete with it, and that plaintiff could recover from defendants profits lost from the competition while they remained in plaintiff's employ. Plaintiff was also allowed to recover all salaries paid defendants after the secret acquisition of the new business.

Some courts take a rather narrow view of what constitutes a corporate opportunity and limit the restrictions placed upon corporate directors and officers in acquisitions of property to property in which the corporation has an already existing interest or in which it has an expectancy growing out of an existing right (e.g., an expectancy that it will be able to renew the lease on property it is already renting). In a Delaware case,[53] for example, Odlum, a man of varied business interests, was part-time president as well as controlling director of Airfleets, an aircraft subsidiary which was interested in making investments; he was also president of Atlas, an investment corporation which was the largest stockholder in Airfleets; and he was trustee or director of numerous other corporations and foundations interested in making investments. He was approached in his individual capacity and given an opportunity to buy the stock and patents of a corporation engaged in manufacturing self-locking nuts used in aircraft. For tax reasons Odlum decided not to take the deal himself, but he was advised that such an investment might "fit very well into the tax problems of Airfleets."[54] Odlum was also advised that because of the possibility of disallowance of royalty payments on renegotiation of government contracts, it would be undesirable for Airfleets to acquire the patents. Accordingly Airfleets' board, controlled by Odlum, voted to invest in the stock,

[52] *Id.* at 421, 34 N.E.2d at 707.
[53] Johnston v. Greene, 35 Del. Ch. 479, 121 A.2d 919 (Sup. Ct. 1956).
[54] *Id.* at 484, 121 A.2d at 922.

and Odlum himself undertook to arrange for the purchase of the patents by third parties.

Airfleets' rejection of the opportunity to buy the patents was attacked in this case as an unlawful diversion of corporate opportunity. The Chancellor held that "when the opportunity came to Odlum to buy the patents, it belonged to Airfleets because Airfleets was seeking opportunities for investment."[55] In reversing this holding the Supreme Court of Delaware noted (1) that the offer had come to Odlum in his individual capacity, (2) that the business of the acquired corporation had "no direct or close relation"[56] to Airfleets' business, and, therefore, (3) that Airfleets had no interest or expectancy in the offer made to Odlum. The court further observed that

> It is one thing to say that a corporation with funds to invest has a general interest in investing those funds; it is quite another to say that such a corporation has a specific interest attaching in equity to any and every business opportunity that may come to any of its directors in his individual capacity. This is what the Chancellor appears to have held. Such a sweeping extension of the rule of corporate opportunity finds no support in the decisions and is, we think, unsound.

The court judged the propriety of Odlum's actions by the "test applicable to a transaction between the dominating director and his corporation—the test of fairness."[58] On this basis it was held that Odlum should not be made to account to Airfleets for the patents transactions.

§ 5.07. *Maneuvers relating to corporate meetings; failure to hold meetings*

By maneuvers connected with meetings of shareholders and directors, corporate managers can sometimes help one group of shareholders or directors gain an advantage over another faction. They can call a shareholders' or directors' meeting at a place inconvenient for one faction; they can give such short notice of a meeting that one group of shareholders does not have time to study and organize resistance to action proposed by another group; and

[55] *Id.* at 486, 121 A.2d at 923.
[56] *Id.* at 487, 121 A.2d at 923.
[57] *Id.* at 488, 121 A.2d at 924.
[58] *Id.* at 492, 121 A.2d at 926.

they can omit from the notice of a meeting important matters to be considered there, with the result that some shareholders are caught by surprise by action proposed. A presiding officer in particular can resort to "steamroller" tactics to push through resolutions objectionable to a group of shareholders.[59]

In a Delaware case, *Canada Southern Oils* v. *Manabi Exploration Co.*,[60] corporate officials, planning to issue additional shares which would deprive plaintiff of voting control, notified the company's directors by telegram of a board meeting to be held in Texas four days later. The two directors representing plaintiff, on receiving the notice in New York, objected to the shortness of the notice and suggested postponement. The request was refused. The other directors attended the meeting and approved issuance of the additional shares.

Plaintiff brought suit to enjoin the issuance of the shares, and the trial court granted the injunction. The appellate court approved, concluding that the primary purpose of the sale of the shares was to deprive plaintiff of majority voting control. The appellate court also pointed out that the officials calling the meeting "did too much too soon with too little disclosure to justify a contrary finding."[61] The court further noted that the possibility of the shares being issued was not mentioned in the notice of the meeting, although the officers apparently were involved in negotiations for their issuance prior to the board meeting.[62]

An interesting Irish case, *Nash* v. *Lancegaye Safety Glass (Ireland) Ltd.*,[63] is somewhat similar. In that case some of the shareholders and directors of the company wanted to issue a sizable block of shares to a former chairman of the board. They supported the issue as necessary to raise needed funds for the company, but other shareholders believed that the principal purpose of the issue was to reward the former chairman for past services (for which he had already been compensated) and to increase his voting strength. A directors' meeting was hurriedly called, and the issue of the shares was approved with "somewhat indecent haste."[64] The court outlined the steamroller tactics in the following language:

[59] See Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App.2d 106, 202 P.2d 748 (1949).
[60] 33 Del. Ch. 537, 96 A.2d 810 (Ch. 1953).
[61] *Id.* at 543, 96 A.2d at 813.
[62] *Id.* at 542, 96 A.2d at 813.
[63] 92 Ir. L.T.R. 11 (1956).
[64] *Id.* at 22.

No agenda or notice of any resolution was sent out beforehand, and in the agenda circulated at the meeting the only heading the matter could be related to was 'capital position,' which was an item appearing in the agenda and discussed at nearly every meeting. Mr. Nash's plea for adjournment and an opportunity of further consideration was rejected rather summarily. The board meeting was being held at a time when the draft accounts for the year 1954 had been prepared—and were in fact discussed at the meeting—and the annual general meeting of the company was due to be held within a month or so. Was there any good or compelling reason why the matter should not have been held over and the whole position put before the company as a whole at that meeting?[65]

In this same case, the annual meeting of shareholders "was deliberately fixed to frustrate as far as possible the wishes and intentions of the shareholders and to insure the confirmation or re-election of the existing directors."[66] "The place of the meeting was fixed for Dublin, instead of, as usual, Templemore, and Mr. Breen [a key company official] made no secret of the fact that this was for the purpose of making it as difficult as possible for the local shareholders to attend."[67]

Corporate officers sometimes deliberately withhold information on the purpose or importance of a meeting, in the hope that persons who will be adversely affected by planned action will neglect to attend. *In re Faehndrich's Petition*[68] is such a case. There the seventy-seven-year-old petitioner was founder of the business and its principal shareholder. For a number of years his oldest son Rudolph had been president; petitioner had served as secretary-treasurer. Although petitioner received a notice of a shareholders' meeting, he failed to attend, apparently believing that shareholder action could not be taken without his being present because the company had a by-law which fixed the quorum for shareholders' meetings at two-thirds of the shares outstanding. Thereafter petitioner received by mail a notice that he had been replaced as director and secretary-treasurer of the corporation and that his employment had been terminated.

[65] *Id.* at 22-23. See also Indianapolis Dairymen's Co-op., Inc. v. Bottema, 226 Ind. 237, 79 N.E.2d 399 (1948), where plaintiff alleged that the corporation had failed to hold annual meetings and to give its members proper notice of those actually held.

[66] 92 Ir. L.T.R. 11, 24.

[67] *Ibid.*

[68] 3 Misc.2d 156, 151 N.Y.S.2d 261 (1956), aff'd mem., 1 App. Div.2d 992, 152 N.Y.S.2d 413 (1956).

Petitioner claimed that he did not know that the purpose of the meeting was to remove him as director and to terminate his employment, and that he was unaware of Rudolph's intention to proceed with the meeting on the assumption that the two-thirds quorum requirement was invalid. Rudolph's position was that the by-law was invalid because contrary to a section of the corporation statute.[69] Without passing on the validity of the by-law, the court held that irrespective of the by-law's validity, the action taken by Rudolph at the meeting could not be sustained because the relation between the parties required "a full and fair disclosure of all material factors bearing upon their transactions with the corporation."[70]

A wide variety of actions and techniques are available to corporate officers who want to take advantage of a particular shareholder or group of shareholders. In one case,[71] company officers stationed a person in police uniform and a supposed private detective in a shareholders meeting, who allegedly stood around "in a menacing and threatening attitude."[72] At a meeting of directors of the same company, the presiding officer refused to count the vote of one of the directors.[73] In other cases, majority shareholders have treated the corporation as their own private enterprise and have simply not held any meetings of shareholders or directors.[74] Thus, corporate officers and salaries have been changed and capital improvements made without authorization of the board of directors.[75]

§ 5.08. *Eliminating or circumventing cumulative voting*

Cumulative voting is a system of voting designed to give minority groups with a substantial number of shares some representation on the board of directors. Under a system of cumulative voting, the

[69] N. Y. Stock Corp. Law § 55.

[70] 3 Misc.2d 156, 162, 151 N.Y.S.2d 261, 264.

[71] Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App.2d 106, 202 P.2d 748 (1949).

[72] *Id.* at 112, 202 P.2d at 751.

[73] *Ibid.*

[74] Letter from Erle B. Askew, dated Nov. 2, 1959.

[75] Letter from William J. Madden, dated Oct. 26, 1959. See also Tansey v. Oil Producing Royalties, 133 A.2d 141, 146 (Del. Ch. 1957), where corporation had been inactive for a number of years and had functioned principally as a "vehicle for the defendant's personal convenience"; financial statements had not been prepared, books had not been independently audited, and officers had been changed without directors electing them.

number of shares held by a shareholder is multiplied by the number of directors to be elected, and the shareholder is permitted to cast the total number of votes arrived at by this process of multiplication for a single nominee, or he may distribute the total number of votes among several nominees if he sees fit. Cumulative voting is to be contrasted with "straight voting," a system of voting under which a shareholder is entitled to cast one vote per share for a candidate for each vacancy to be filled on the board; holders of a bare majority of shares can therefore elect the entire board of directors.

Cumulative voting gives minority shareholders a "watchdog" on the board who can report to minority shareholders the actions of directors elected by majority interests. The presence of minority representatives on the board often creates in majority shareholders and in management fear that misdeeds, real or supposed, will be reported to minority shareholders and that derivative actions will follow. Majority shareholders may resort to a number of devices to eliminate or circumvent cumulative voting.

Many states have constitutional or statutory provisions which require cumulative voting for directors. In other states, however, the statutes make cumulative voting permissive; the charter or by-laws control whether or not directors are elected by cumulative voting. A third group of states has no constitutional provisions or statutes on cumulative voting.[76] In states of the latter two types, where the right to vote cumulatively is permissive rather than mandatory, majority shareholders can amend a corporation's charter to replace cumulative voting with straight voting.[77]

Cumulative voting can also sometimes be circumvented by the majority shareholders' removing without cause directors elected by minority shareholders, and replacing them with majority-sponsored directors.[78] Another way of frustrating cumulative voting is to reduce the number of directors.[79] If a group of minority shareholders con-

[76] See generally on cumulative voting, Ballantine, Corporations § 177 (rev. ed. 1946). For a list of the statutory provisions in the various states, see Freeman and Wolf, Cumulative Voting in the United States, Bus. Law., Nov. 1955, p. 123.

[77] See Maddock v. Vorclone Corp., 17 Del. Ch. 39, 147 Atl. 255 (Ch. 1929). But see Application of N. Y. Hanseatic Corp., 200 Misc. 530, 103 N.Y.S.2d 698 (1951) (charter amendment abolishing cumulative voting entitles shareholders adversely affected to an appraisal and purchase of their shares).

[78] See Bowes and De Bow, Cumulative Voting at Elections of Directors of Corporations, 21 Minn. L. Rev. 351, 366-367 (1936).

[79] See Bond v. Atlantic Terra Cotta Co., 137 App. Div. 671, 122 N.Y. Supp. 425 (1910). See also Curran, Minority Stockholders and the Amendment of Corporate Charters, 32 Mich. L. Rev. 743, 764-765 (1931).

trols 17 shares in a corporation with a total of 100 shares outstanding, under a system of cumulative voting they could always elect one director of a five-man board. If the size of the board is decreased to three, however, the minority shareholders, although not deprived of their right to vote cumulatively, have been effectively deprived of representation on the board. A similar result can be achieved by issuing additional shares to majority shareholders without increasing the number of shares held by the minority.

In some states it is possible to defeat cumulative voting by classifying the board of directors and staggering board elections. The charter can be amended to provide for only part of the directors to be elected each year, with (for example) each director serving for a term of three or five years. Thus the Class A directors would be elected in 1961, the Class B directors in 1962, and so on. As only a fraction of the directors would then be voted on at any one time (conceivably only one director would be elected each year), cumulative voting would be of little or no value to minority shareholders. Nevertheless, a number of courts,[80] even in jurisdictions with constitutional provisions or statutes making cumulative voting mandatory in elections of directors, have sustained arrangements providing for the staggering of board elections.

§ 5.09. *Manipulations of stock transfer restrictions*

In close corporations restrictions are commonly placed on the transferability of stock.[81] In most jurisdictions reasonable restrictions on transferability are sustained irrespective of whether they are placed in the charter, in by-laws, or in contracts among the participants (sometimes called "restrictive stock agreements"). To be given effect, however, at least as against persons without knowledge of them, the restrictions must also be stated on the share certifi-

[80] See Humphrys v. Winous Co., 165 Ohio St. 45, 133 N.E.2d 780 (1956); Jenney v. Philadelphia Transportation Co. 387 Pa. 282, 128 A.2d 76 (1956). Contra: Wolfson v. Avery, 6 Ill.2d 78, 126 N.E.2d 701 (1955). "A board of three with only one director in each class, each class being elected for three years, would do away with cumulative voting. A board of six, with only two members elected each year would in many cases be no better." Ballard, Arrangements for Participation in Corporate Management under the Pennsylvania Business Corporation Law, 25 Temp. L.Q. 131, 139 (1951).

[81] See generally Cataldo, Stock Transfer Restrictions and the Closed Corporation, 37 Va. L. Rev. 229 (1951). For a discussion of the planning and drafting of transfer restrictions, see O'Neal, Close Corporations: Law and Practice, ch. VII (1958).

cates.[82] The most popular type of restriction is the "first option" provision, which provides that the other shareholders or the corporation shall have a first right or "first option" to buy shares of a holder who dies or decides to sell.

Whenever shares are subject to "first option" provisions, each shareholder usually thinks that such provisions give him the right to buy his proportionate part of the shares of any holder who dies or decides to sell, and in many situations he probably expects that such restrictions will also operate to prevent any one person from getting a clear majority of the company's shares. A shareholders's expectations in this regard may be disappointed by one of his associates selling shares to another associate without observing the restriction. Most courts narrowly construe restrictions on transferability; consequently when these provisions are not specific, courts are likely to hold that they apply only to sales to outsiders.[83] The purpose of restrictive arrangements, some courts say, is to keep strangers out, and not to prevent a sale by one existing shareholder to another.[84]

If the corporation rather than the other shareholders has the first option to purchase shares of a holder who dies or decides to sell, the stage is set for another kind of squeeze-play. The directors (they may or may not be majority shareholders) may cause the corporation to elect not to exercise its rights under the first option arrangement and thus free the shares for unrestricted sale to controlling shareholders or their nominees. Such manipulation of course can enable directors or majority shareholders to increase their proportionate holdings without a similar increase in the holdings of minority shareholders.

In the interesting case of *Brown* v. *Dolese*,[85] a family corporation was engaged in quarrying and selling limestone and other building materials, and in conducting a highly profitable transit-mix concrete business. The company's stock was held by members of two branches of the family—the Doleses and the Schofields. Roger Dolese was

[82] See Uniform Stock Transfer Act § 15.

[83] Serota v. Serota, 168 Misc. 27, 5 N.Y.S.2d 68 (1938); Guaranty Laundry Co. v. Pulliam, 198 Okla. 667, 181 P.2d 1007 (1947); Pomilla v. Bumgardner, 326 S.W.2d 917 (Tex. Civ. App. 1959); Rychwalski v. Baranowski, 205 Wis. 193, 236 N.W. 131 (1931). Contra: Coleman v. Kettering, 289 S.W.2d 953 (Tex. Civ. App. 1956).

[84] See Pomilla v. Bumgardner, 326 S.W.2d 917 (Tex. Civ. App. 1959).

[85] 154 A.2d 233 (Del. Ch. 1959), aff'd, 157 A.2d 784 (Del. Sup. Ct. 1960). For further discussion of this case, see Appendix, Case 2, *infra*.

president; his brother-in-law, William Schofield, was vice-president. All the shareholders had entered into an agreement not to sell their stock without first offering it to the other shareholders and to the company. After differences had arisen between Roger Dolese and William Schofield and the Schofields had threatened legal action, Roger persuaded the Schofields to sell their shares at a specified price (the price was said to be "substantially less than the real value of such stock, . . . 'as Roger well knew' ").[86]

Roger thereupon allegedly evolved a scheme for a sort of double squeeze-play, a plan which would not only eliminate the Schofields but also reduce substantially the participation of the other Doleses—Roger's mother, brother, and sisters. The story of avarice and double-dealing set forth in a complaint by Roger's sisters and other relatives is in brief as follows.

Roger represented to the Doleses that it was necessary to the company's future success to eliminate the Schofields. Concealing the fact that the company had ample assets and credit to purchase the Schofield interest, he induced the Doleses to believe that the company was not in a condition to make the purchase. He organized a new company wholly owned by himself to purchase the Schofield stock. He then called a special meeting of the old company's directors, and he and an accomplice, being the only directors present, passed a resolution waiving the company's right under a first-option agreement to purchase the Schofield stock. Thereafter, acting as president of the old company, as agent with power of attorney for most of his relatives, and as a trustee for one of his sisters, Roger waived both the company's rights and his relatives' rights to purchase the stock and thus opened the way for its acquisition by the new company. Subsequently, through complicated maneuvers that included partial liquidation of the old company and a "spin off" of part of its assets to the new company, the latter acquired, at a very low cost, 40 per cent of the assets of the old company and the most profitable and promising part of its business, namely, the transit-mix concrete operations.

In effect, the payment to the Schofields for their stock was made with cash transferred by the old company to the new company plus an amount borrowed from a bank on the security of Roger's stock and a chattel mortgage on assets transferred to the new com-

[86] 154 A.2d at 236.

pany. Roger attempted to explain away these transactions, claiming that they were "designed to eliminate the threat to the business posed by the Schofields and further that The Dolese Company [the new corporation] had been organized for tax purposes in the course of consummating at great personal sacrifice a transaction which was essentially for the family's benefit."[87]

Setting forth this story in their complaint, two of Roger's sisters and other relatives brought a derivative suit to recover for the old company the assets and property which Roger had converted and the profits which he had gained from their use. Roger moved to dismiss the complaint, principally on the ground that the complaint showed plaintiffs had in one way or another ratified or approved the challenged transactions. The Vice Chancellor held, however, that the allegations of the complaint were sufficient to withstand a motion to dismiss, and that Roger had the burden of establishing that plaintiffs' approval had been given with knowledge of all material facts bearing on the fairness of the transaction.

The Vice Chancellor's decision was affirmed by the Supreme Court of Delaware,[88] which summed up the case in the following language:

> If the allegations are true, Roger, as a result of the various steps taken, has appropriated for himself the most valuable part of the corporate business by using corporate funds for the purpose, and has secured the consent of the other stockholders thereto by false representations and concealment.[89]

The Supreme Court went on to say that the restrictive stock agreement "gave the corporation some sort of expectancy in the purchase of the stock. . . . The exact scope of the expectancy is not important; it is enough to say that Roger recognized its existence and undertook (in effect) by unilateral action to waive the corporate rights for his own benefit."[90]

In a Massachusetts case, *Kentucky Package Store Inc.* v. *Checani,*[91] the representative of an estate was able to defeat an option which had been given for the purchase of the estate's interest in a business. Here the corporation had an option to purchase the shares of a

[87] *Id.* at 238.
[88] 157 A.2d 784.
[89] *Id.* at 787.
[90] *Ibid.*
[91] 331 Mass. 125, 117 N.E.2d 139 (1954).

deceased majority shareholder. The company's directors were deadlocked on whether to purchase. The deceased's administratrix, who was president of the company, called a special meeting of the shareholders at which she voted the deceased's shares against the purchase. The court held that the shares were properly voted. The result of course was that the administratrix was able to circumvent the option arrangement and retain for herself and the other heirs a controlling interest in the company.

§ 5.10. *Refusal of young shareholders to adjust periodically the transfer price of shares subject to a survivor-purchase agreement*

Participants in a small business, irrespective of whether it is conducted in the corporate or in the partnership form, not uncommonly enter into a survivor-purchase or other buy-out arrangement providing for the surviving participants to purchase the interest of a participant who dies or becomes incapacitated. A number of methods and formulae are available for fixing the price at which shares in a corporation or an interest in a partnership will be transferred under one of these buy-out arrangements.[92]

Sometimes the participants, in negotiating a survivor-purchase agreement, designate a transfer price which they consider to represent the fair value of a share or fractional interest in the enterprise, and undertake to meet from time to time and adjust the price to reflect growth or other changes in the business. In a prosperous and rapidly growing business in which some of the participants are young and in good health while others are old and feeble, the young men may arbitrarily refuse to negotiate in good faith for modification of the price, knowing that the great odds are that they will survive and thus acquire the shares at a price lower than their actual value.

In *Helms* v. *Duckworth*,[93] Easterday, age seventy, and Duckworth, age thirty-seven, executed a contract to form a corporation with 1,500 shares of $10 par value stock. Easterday, who had been engaged in the roofing and sheet metal business for forty-five years, was to transfer his business to the new corporation and was to re-

[92] See O'Neal, Close Corporations: Law and Practice, § 7 (1958).
[93] 249 F.2d 482 (D.C. Cir. 1957).

ceive 51 per cent of the stock. Duckworth was to buy the remaining 49 per cent for cash. The parties executed a survivor-purchase agreement which provided that a surviving shareholder would have an option to purchase the shares of a holder who died at the par value of $10 per share, but that the transfer price might be redetermined and changed during the month of January in any year while the agreement remained in force.

When the agreement was made, the $10 per share figure reflected net worth of the company. On Easterday's death seven years later, the value of the stock was about $80 per share.

Easterday's administratrix brought suit to cancel the survivor-purchase agreement, urging that Duckworth fraudulently induced Easterday to execute it by representing that he (Duckworth) would consent to a periodic redetermination of the stock purchase price. Duckworth stood on the letter of his contract, arguing that he was entitled to buy the deceased's shares at $10 a share as there had been no mutually agreed change in the purchase price.

The United States Court of Appeals for the District of Columbia construed the agreement to mean that yearly adjustment would be made in price to conform to the realities of the company's rising or declining net worth, and clearly to contemplate a periodic bargaining or negotiating process in which each party participated in good faith. Good faith in this context, the court went on to say, means more than merely going through the motions of negotiating; it is inconsistent with a predetermined resolve not to budge from an initial position.[94]

After interpreting Duckworth's affidavit to mean that he had never intended to consent to any change in the purchase price, the court held that failure to disclose this intent was a breach of fiduciary duty (owed by one shareholder in a close corporation to another) which warranted cancellation of the agreement. Duckworth's "failure to disclose to his corporate business partner his fixed intent never to alter the original price constitutes a flagrant breach of a fiduciary duty."[95]

Another ground for requiring a high degree of good faith from Duckworth was that he was trained in both business administration and law, while Easterday had no training or experience in drafting contracts; therefore, Duckworth should be compelled to reveal to

[94] *Id.* at 486.
[95] *Id.* at 487.

Easterday any possible conflicts of interest. The court indicated that upon the present record the administratrix was entitled to summary judgment, but it remanded the cause to give Duckworth an opportunity to establish the fairness of the transaction.

While the court granted relief to the squeezee in *Helms* v. *Duckworth,* it is to be noted that Duckworth lost his case by an ambiguous statement in his affidavit, which the court construed as an admission that he never intended to negotiate in good faith for changes in the transfer price. Actually, if a participant goes through the process of bargaining (though refusing to raise the transfer price) and is careful not to admit a lack of good faith, a court will find it difficult to cancel the survivor-purchase agreement or to refuse approval of a transfer at the price initially fixed.

§ 5.11. *Squeeze-outs of majorities by minorities*

Occasionally a minority shareholder or a group of minority shareholders, rather than attempting to purchase the majority's controlling shares, evolves another scheme for seizing control from the majority. Such minority schemes have taken a number of forms.[96]

Standard International Corporation v. *McDonald Printing Co.*[97] is an interesting case in which minority shareholders succeeded in gaining control of their company. There, five of the corporation's eight shareholders constituted its board of directors. Two of the directors, who together owned slightly more than 50 per cent of the company's outstanding shares, entered into a contract to sell their shares to an outsider at $33 per share. The other three directors were opposed to the sale, and the directors by a vote of three to two authorized the issuance of seven thousand additional shares to Walter McDonald, one of the three directors, at a price of $37.50.

The company's charter contained clauses (1) waiving shareholders' pre-emptive rights and (2) providing that stock issues should be subscribed for and sold as determined by resolution adopted by a majority of the board of directors. The action of the directors in issuing the shares to McDonald was challenged on the ground that

[96] In Application of Burkin, 1 N.Y.2d 570, 154 N.Y.S.2d 898, 136 N.E.2d 862 (1956), the minority shareholder in a two-man company brought an arbitration proceeding to have the majority shareholder removed from the directorate for alleged misconduct.

[97] 159 N.E.2d 822 (Ohio C. P. 1959).

since McDonald's vote was necessary for passage of the resolution, the resolution had not received the favorable vote of a disinterested majority of directors.

The court, however, sustained the board's action, holding that the articles of incorporation are the basis for individual corporate existence and "lay the foundation and limits for corporate action." The decision was influenced by the fact that this was a closely held corporation and that the participants undoubtedly had contemplated that a majority of the shares would not be transferred to an outsider. The court commented that the testimony showed that the purpose of the three directors in selling the stock to McDonald was to "perpetuate the company on the basis it had originally been set up."[98]

In *Chapman* v. *Barton*[99] minority shareholders made a bold attempt to seize control of the company. For many years it had been the custom to conduct the annual shareholders' meeting in an informal manner, and directors had been selected by oral vote or agreement. On this occasion majority interests moved to retain existing board members, expecting a voice vote as usual. A minority shareholder, however, demanded vote by ballot. The presiding officer, a member of the majority group, became suspicious and announced that the meeting would adjourn until legal advice could be obtained. All parties left the meeting place without further protest. After the majority group had departed, the minority returned to the room and conducted an election of directors. Thereafter members of the minority group took physical possession of the company's property and proceeded to hire and fire employees and otherwise conduct the business.

Majority shareholders brought an action to enjoin the minority from purporting to act as directors and officers of the corporation. The court held that plaintiffs were entitled to the injunction, commenting: "Courts of equity do not look with favor on attempts of a minority group to seize control of a corporation by trying to trap the majority without legal advice."[100] The court went on to note another reason for granting equitable relief, pointing out that since defendants had actually taken physical possession of the company's business and property, the suit was not merely one to try title to an

[98] *Id.* at 824.
[99] 345 Ill. App. 110, 102 N.E.2d 565 (1951).
[100] 345 Ill. App. at 114, 102 N.E.2d at 567-68.

office but also to restrain unauthorized persons from interfering with management.[101]

In *Frank* v. *Anthony*,[102] the two defendants, neither of whom held any stock in the corporation, succeeded in seizing at least temporary control from plaintiff, the sole shareholder. Shortly after incorporation, defendants, who were two members of the three-man board of directors, passed a resolution removing plaintiff from his position as president of the company. On the same day plaintiff held a meeting of the shareholders and purported to remove the board of directors and appoint a new board which he could control. Several months later, plaintiff held another shareholders' meeting and amended the company's by-laws to authorize the removal of directors with or without cause upon a majority vote of the shareholders. At this meeting he also ratified the previous action of the shareholders in removing the old directors.

Plaintiff sought a declaratory judgment that he was president of the company, an injunction restraining defendants from acting as officers, and an order requiring the bank to honor only plaintiff's checks. The trial court entered a judgment against the plaintiff, holding that directors can remove corporate officers, including the president, without cause but that shareholders cannot remove directors without cause in the absence of specific authority in the charter or by-laws. On appeal, the Florida District Court of Appeal affirmed. The court indicated that if plaintiff's employment contract had been breached, he had a cause of action based on the breach, but that even if he were the sole shareholder he had no power under the charter or by-laws to remove directors without cause prior to the expiration of their terms or (at that particular time) to amend the by-laws.

Certain additional facts in this case may explain the court's readiness to permit defendants to take over control of the corporation. Plaintiff and defendants were also interested in a partnership which had been organized soon after the corporation, and defendants had contributed substantial sums of money to the partnership to enable it to purchase certain real property. The corporation was given an option to buy the land from the partnership, and an agreement was entered into among the participants by which the corpo-

[101] 345 Ill. App. at 115, 102 N.E.2d at 568.
[102] 107 So.2d 136 (Fla. App. 1956).

ration would issue stock to the partners according to their proportionate interest in the partnership, with plaintiff being given an option to buy a specified additional amount of stock. In the meantime plaintiff, without informing defendants, had caused five hundred shares of stock to be issued to himself. All of the original incorporators except plaintiff had resigned, and when vacancies were created on the original board of directors by the resignations of the other incorporators, plaintiff filled the vacancies by appointing defendants as directors. In sum, plaintiff and defendants from the beginning had contemplated that defendants would become shareholders in the corporation; plaintiff had apparently tried to squeeze defendants out of a new and promising enterprise; defendants had merely turned the tables on him.

This case illustrates that even in a one-man company the sole shareholder may well have some concern about his power to control the directors during their term of office. Some years ago at a panel of the American Bar Association Section of Corporation, Banking and Business Law the following problem was posed for discussion: "Let us assume that the business has been run as a sole proprietorship. The proprietor's daughter was married a year or so ago. The proprietor gave his new son-in-law a job to keep peace in the family, but he does not like the fellow. Upon being incorporated the logical people to become directors are the proprietor, his wife and the son-in-law. The proprietor is fearful that his wife and daughter and son-in-law may combine against him and cause him difficulties even if he holds control of all of the stock."[103]

In the case of *In re Maguire's Petition,*[104] minority shareholders evolved an ingenious plan for seizing control of their corporation. After rather extensive maneuvering and struggle for control, a vacancy occurred on the five-man board of directors. The remaining four directors met pursuant to the by-laws to fill the vacancy, but they became deadlocked by an equal division. The shareholders then met and amended the by-laws to permit the shareholders by majority vote to fill vacancies on the board of directors whenever such vacancies were not filled by the remaining board members within

[103] Proceedings at the Annual Meeting of the Section of Corporation, Banking and Business law (August 16-17, 1954), Bus. Law., Nov. 1954, p. 10.

[104] 5 Misc.2d 256, 160 N.Y.S.2d 443 (1956); aff'd mem., 3 App. Div.2d 693, 159 N.Y.S.2d 470 (1957); motion for leave to appeal denied, 3 App. Div.2d 813, 160 N.Y.S.2d 840 (1957).

thirty days. Each of the two factions nominated a candidate for the vacancy on the board.

As the vote was taken, the shareholders whose candidate was being defeated, faced with the prospect of ouster from the company's management, conceived a scheme for gaining control of the corporation. One of the minority shareholders challenged the right of the principal majority shareholder to vote, without giving any specific reason for the challenge. After the adjournment of the meeting and after two of the shareholders had left, the minority shareholder disclosed for the first time that his challenge was based upon a provision of the corporation law[105] requiring a challenged shareholder to take an oath that his vote has not been sold.

The challenged shareholder, upon being advised of the reason for the challenge, suggested that the meeting be reopened and expressed his willingness to take the oath. The minority shareholders refused to consent to a reopening of the meeting, arguing that new notices would be required and pointing out that two shareholders had already left the meeting. The position of minority shareholders was that the majority shareholder's vote could not be counted and that, therefore, their nominee had been duly elected director of the company. At the directors' meeting which followed, the minority nominee participated as a director and voted upon various corporate matters, including election of officers.

Majority shareholders thereupon brought a summary proceeding to set aside the alleged election of the director and the alleged election of corporate officers. The court ordered a new election for the vacancy on the board of directors and a new election of officers, holding that it could not sanction a procedure whereby a mere technicality was used to circumvent the will of a majority of the shareholders.

Under cumulative voting, an alert minority may on occasion be able to seize control of the corporation from an unwary or inept majority that spreads its votes among too many candidates.[106] To minimize that possibility, statutes[107] in a few states require share-

[105] N.Y. Gen. Corp. Law § 20.

[106] The fact that the shareholders holding a minority of the stock might sometimes elect a majority of the board has been the basis for considerable criticism of cumulative voting. See Axley, The Case Against Cumulative Voting, 1950, Wis. L. Rev. 278, 282; Bowes and DeBow, Cumulative Voting at Elections of Directors of Corporations, 21 Minn. L. Rev. 351, 362 (1937).

[107] See, e.g., Minn. Stat. Ann. § 301.26 (3) (1947); Ohio Rev. Code Ann. § 1701.55 (Page Supp. 1959).

holders who intend to vote cumulatively to give notice of that intention a specified number of hours in advance of the shareholders' meeting. In the absence of a statute of this kind, a shareholder need not give notice (either before or during the shareholders' meeting) of his intention to vote cumulatively.[108]

Minority shareholders sometimes obtain the assistance or cooperation of corporate creditors, suppliers, or employees in bringing pressure to bear on majority shareholders. Thus, through pressure exerted by bondholders,[109] two of the six shareholder-directors of Theater Guild were able to obtain a reorganization of the Guild which gave them practically unfettered control of the Guild and its productions. In another case a minority shareholder, who was also the company's president, persuaded a key employee to request release from his employment contract; he also caused the termination of the company's distributorship by announcing his intention to withdraw from the company and by undermining the manufacturer's confidence in the ability of the other shareholder to handle the distributorship.[110]

§ 5.12. *Possibilities of squeeze-plays under subchapter S*

Subchapter S of the Internal Revenue Code[111] introduced a new form of business organization, namely the "tax option" corporation. If a small business corporation meets the requirements of Subchapter S, it can elect to have corporate income or loss pass to the shareholders for federal income tax purposes. Whenever a valid election has been made, the corporation's undistributed taxable income is taxed to the shareholders as though it were distributed to them as a dividend on the last day of the corporation's taxable year.

Subchapter S opens up a number of opportunities for a shareholder in a small corporation to exact concessions from his associ-

[108] Pierce v. Commonwealth, 104 Pa. 150 (1883). See also Commonwealth *ex rel.* Laughlin v. Green, 351 Pa. 170, 40 A.2d 492 (1945).

[109] Simonson v. Helburn, 198 Misc. 430, 97 N.Y.S.2d 406, (1950).

[110] Nichols-Morris Corp. v. Morris, 174 F. Supp. 691 (S.D.N.Y. 1959).

[111] Int. Rev. Code of 1954 §§ 1371-1377 (added by Technical Amendments Act of 1958—72 Stat. 1606). See generally, Anthoine, Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment, 58 Colum. L. Rev. 1146, 1147-1174 (1958); Optional Taxation of Closely Held Corporations Under the Technical Amendments Act of 1958, 72 Harv. L. Rev. 710 (1958).

ates as the price for his co-operating in their obtaining advantageous tax treatment. In the first place, since all shareholders must consent to the making of an election,[112] a shareholder who will not benefit from an election can withhold his approval until he has been "bought off" by associates. Second, after an election has been made, if the tax circumstances of majority shareholders change and they want the corporation to terminate the election, a single shareholder is in a position to prevent the termination because again the consent of all shareholders is required.[113] Third and perhaps most serious of all, after a corporation has made an election, any dissatisfied shareholder, even though he holds only one or two shares, can upset the tax planning of all his associates by resorting to any of a number of procedures which will automatically terminate the election.[114] He can accomplish that result by transferring his shares to a partnership, another corporation, a trust, a non-resident alien, or any other non-qualifying shareholder; by transferring his shares to a new shareholder who will not consent to the election;[115] or by splitting up his holdings and disposing of them to various persons so as to increase the total number of shareholders in the corporation to more than ten, the maximum number permissible in a "tax option" corporation.

One way to guard against a minority shareholder's acting arbitrarily to terminate an election is to place restrictions on the transferability of the corporation's shares. Resort might be had, for example, to the popular first-option provision which requires that the shares of a holder who dies or decides to sell must first be offered to the corporation or the other shareholders. Such a restriction, however, places the minority shareholder in a particularly vulnerable position. If the corporation makes the election he must pay tax on his proportionate share of corporate income even though the income is not distributed to him. At the same time, distributions of

[112] Regulations § 1.1372-1 provides in part as follows: "The election by a small business corporation is valid only if all the shareholders in the corporation on the first day of the first taxable year for which the election is to be effective, or on the date of election, whichever is later, consent to such election."

[113] Regulations § 1.1372-4 (b) (2) provides in part that an election "may be revoked by the corporation for any taxable year of the corporation after the first taxable year for which the election is effective. A revocation can be made only with the consent of all the persons who are shareholders at the beginning of the day of revocation."

[114] See Kemp, Applications of Subchapter S, 109 J. Accountancy 51, 54 (1960).

[115] See Anthoine, Subchapter S of the Internal Revenue Code: Corporate Tax Election to Pass Income and Loss to Shareholders 7 (Practising Law Institute 1959).

earnings are entirely within the discretion of the board of directors. Thus he may be required to pay tax on corporate income even though he is not receiving any of that income to help him meet tax obligations.[116]

§ 5.13. *Denying squeezee access to corporate properties, books and records*

Not uncommonly a shareholder who is being squeezed, even though he has a substantial interest in the business, is denied access to corporate books and records.[117] Sometimes he is even physically barred from entering corporate offices.[118]

Withholding of information here is ancillary to the use of other squeeze-out techniques and is frequently resorted to by squeezers to conceal their other activities. Thus information as to corporate affairs may be withheld as part of a scheme to force the minority to dispose of their stock at less than fair value.[119] Also, access to records may be denied as an adjunct to withholding dividends, in order to keep from the squeezees the fact that the corporation has funds available to pay them.[120] Additionally, stockholders' lists may be withheld from minority shareholders in order to prevent them from soliciting assistance in bringing a suit against the majority.[121]

Most often a participant is denied access to business records and information because of the desire of a squeezer to conceal some

[116] See Kemp, Applications of Subchapter S, 109 J. Accountancy 51, 54-55 (1960).

[117] See, e.g., Green v. National Advertising & Amusement Co., 137 Minn. 65, 162 N.W. 1056 (1917); Paulman v. Kritzer Radiant Coils, Inc., 143 A.2d 272 (Del. Ch. 1958); Robb v. Eastgate Hotel Inc., 347 Ill. App. 261, 106 N.E.2d 848 (1952); Laurel Springs Land Co. v. Fougeray, 50 N.J. Eq. 756, 26 Atl. 886 (1893); Falfurrias Immigration Co. v. Spielhagen, 61 Tex. Civ. App. 111, 129 S.W. 164 (1910). Compare Casey v. Grantham, 239 N.C. 121, 79 S.E.2d 735 (1954). See also Graham v. McAdoo, 135 Ky. 677, 123 S.W. 260 (1909).

[118] Kesten v. Morris, 194 N.Y.S.2d 12 (Sup. Ct. 1959). Compare Schroer v. Schroer, 248 S.W.2d 617 (Mo. 1952) (D told co-partner P not to interfere with the work, that D did not want P to see what was being done, offered P $100 per week to stay out of the shop, changed the partnership bank accounts so that P could not draw therefrom, and changed the lock on the door of the building in which the business was conducted); Dillard v. John Chatmas Wholesale, 286 S.W.2d 675 (Tex. Civ. App. 1956); Trade Auxiliary Co. v. Vickers, L.R. 16 Eq. 303 (1873).

[119] See, e.g., Flemming v. Heffner & Flemming, 263 Mich. 561, 248 N.W. 900 (1933); Hornstein, A Remedy for Corporate Abuse—Judicial Power to Wind Up a Corporation at the Suit of a Minority Stockholder, 40 Colum. L. Rev. 220, 233 (1940).

[120] See, e.g., Paulman v. Kritzer Radiant Coils, Inc., 143 A.2d 272 (Del. Ch. 1958); Laurel Springs Land Co. v. Fougeray, 50 N.J. Eq. 756, 26 Atl. 886 (1893).

[121] Robb v. Eastgate Hotel Inc., 347 Ill. App. 261, 106 N.E.2d 848 (1952).

fraudulent or near-fraudulent activity. Thus in the leading case of *Laurel Springs Land Co.* v. *Fougeray,*[122] it was alleged that defendants denied plaintiff access to the records, voted themselves high salaries and commissions, refused to declare proper dividends, and fraudulently conveyed the corporate assets and property to a corporation under their control. Another case[123] involved majority shareholders who denied plaintiff access to corporate books and records, summarily removed him from his position, and organized competing businesses to which they siphoned off profits and various opportunities of the original corporation.[124]

In a well-known case involving the activities of the owners of the "Around the World Shoppers Club, Inc.," plaintiff (holder of 30 per cent of the stock) charged defendants with mismanagement, self-dealing and co-mingling of the affairs of the corporation with those of their own businesses.[125] Plaintiff alleged that all of the administrative functions of the club were performed for it by companies owned and operated by the defendants, who had charged approximately $1,000,000.00 for these services over a period of four years.[126] At the time the complaint was filed, plaintiff applied for an order granting inspection of the records of the club. This was granted.[127] A firm of certified public accountants audited the records but reported that no substantial information had been obtained and that it was necessary to inspect the records of defendants' other companies. Following a court order permitting this second inspection, the accountants reported that there had been "a deliberate and pervasive refusal to permit the inspection of records in almost every area where definitive records were sought."[128] The Appellate Division of the Superior Court of New Jersey affirmed an order of the Chancery Division appointing a 'special fiscal agent' for the club with "full power and authority to check the propriety of all disbursements to be made or proposed to be made by the corporation."[129]

[122] 50 N.J. Eq. 756, 26 Atl. 886 (1893).

[123] Falfurrias Immigration Co. v. Spielhagen, 61 Tex. Civ. App. 111, 129, S.W. 164 (1910).

[124] See Roach v. Margulies, 42 N.J. Super. 243, 126 A.2d 45 (1956); Henry v. Ide, 208 Ala. 33, 93 So. 860 (1922). See also allegations in Hall v. John S. Isaacs & Sons Farms, 146 A.2d 602 (Del. Ch. 1958).

[125] Roach v. Margulies, 42 N.J. Super. 243, 126 A.2d 45 (1956), also discussed §§ 5.03 *supra*, 8.09 *infra*.

[126] Brief for Plaintiff-Respondent, p. 5, Roach v. Margulies, 42 N.J. Super. 243, 126 A.2d 45 (1956).

[127] *Id.* at 9.

[128] *Id.* at 11.

Minority shareholders have been denied access to records for various other reasons including pure vindictiveness following a period of dissension.[130] On the other hand, it is also true that a shareholder sometimes desires information only for a purpose detrimental to the corporation,[131] e.g., to aid a competitor.

At common law, a shareholder has the right, himself or through his accountant or attorney, to inspect corporate books and records at a reasonable time and for a proper purpose.[132] The purposes for which this right, enforceable by mandamus, may be exercised, include inspection by a shareholder for evidence of

> possible or suspected mismanagement, to determine the corporation's financial condition, to ascertain whether dividends may be declared, to obtain a list of shareholders in order to solicit their proxies, to ascertain the value of his shares, to obtain information to aid in litigation or anticipated litigation with the corporation, its officers and directors, as to corporate acts which he hopes to attack, and other purposes aimed at protecting his corporation or his own rights and interests.[133]

The common law right applies to "all records relevant to show the true condition of the company and whether it is being mismanaged or not."[134] Some years ago statutes were enacted in a number of jurisdictions which by their terms seemed to grant shareholders an absolute right to inspect corporate books. At the present time, however, most statutes (either as a consequence of legislative amendment or of judicial interpretation) have reverted to the common law requirement that inspection must be for a proper purpose. Statutes in some states which grant shareholders the right, under certain conditions, to inspect stated records have been construed as supplementing rather than limiting common law rights.[135]

This right to inspect corporate books and records is important

[129] 42 N.J. Super. at 245, 126 A.2d at 46. See Lattin, Corporations 291 (1959).

[130] See, e.g., Green v. National Advertising & Amusement Co., 137 Minn. 65, 162 N.W. 1056 (1917).

[131] In Hutson v. Brown, 248 Ala. 215, 26 So.2d 907 (1946), petitioner, a competitor of corporation, purchased stock and demanded financial statements which he proceeded to show to corporation employee, suggesting to employee that he obtain a new job because of alleged insolvency of corporation. Corporation's officers thereafter refused further information to petitioner. The court held that petitioner was not privileged to examine books for purposes detrimental to the corporation and its shareholders. See also Robb v. Eastgate Hotel, 347 Ill. App. 261, 106 N.E.2d 848 (1952).

[132] Lattin, Corporations 286 (1959); Stevens, Corporations 488 (2d ed. 1949).

[133] Lattin, Corporations 287 (1959).

[134] *Id.* at 288.

[135] *Id.* at 288, 289; Stevens, Corporations 490 (2d ed. 1949). See Rohrlich, Law and Practice in Corporate Control 62 (1933).

for several reasons. Because of the close personal relationship between shareholders in a closely held business, the fact that generally they all participate actively in the business, and the fact that shareholders frequently treat their fellow participants as "partners," each shareholder should be in a position to learn what is going on in those parts of the business in which he is not personally engaged. Moreover, since Securities and Exchange Commission regulations often do not reach closely held businesses, and since small business enterprises sometimes either do not employ independent certified public accountants or limit the scope of their examination,[136] the shareholder should be able to inspect himself or send his accountant or lawyer to inspect for him.

Utilization of the right of inspection at periodic intervals may prevent a prospective squeeze-play or enable a prospective squeezee to counter squeeze-out action before it has gone too far. As Chester Rohrlich has said:

> While knowledge may not be power in corporate affairs, it is beyond dispute that without adequate knowledge of the corporation's affairs a stockholder . . . is in no position successfully to assert any legal rights or even wisely to exercise any non-legal right.[137]

The right of inspection may be enforced in a mandamus action under the common law or applicable statutory provisions,[138] or in a general equity action or proceeding to remedy a squeeze-play.[139] Two cases illustrate how the right of inspection can be enforced in an equitable proceeding. In *Laurel Springs Land Co.* v. *Fougeray,*[140] the court ordered fraudulent conveyances set aside and directed that plaintiff be granted access to the books. The court retained continuing jurisdiction of the case, granting plaintiff leave to apply for further relief if the necessity should arise in the future. In *Kesten* v. *Morris,*[141] the court indicated that petitioner's application for ap-

[136] But see Blough, Accounting and Auditing Prolems, 109 J. Accountancy 77-78 (1960), in which the Director of Research, American Institute of CPAs renders an opinion on the responsibility of a C.P.A. where he learns that financial information has been withheld or misstated, commenting that "the C.P.A. has as much responsibility for full disclosure of significant facts to one partner as to another."

[137] Rohrlich, Law and Practice in Corporate Control 55 (1933).

[138] See Lattin, Corporations 287, 289 (1959).

[139] This frequently takes the form of a proceeding for appointment of a receiver. See, e.g., Henry v. Ide, 208 Ala. 33, 93 So. 860 (1922); Paulman v. Kritzer Radiant Coils, Inc., 143 A.2d 272 (Del. Ch. 1958); Roach v. Margulies, 42 N.J. Super. 243, 126 A.2d 45 (1956).

[140] 50 N.J. Eq. 756, 26 Atl. 886 (1893).

[141] 194 N.Y.S.2d 12 (Sup. Ct. 1959).

pointment of a receiver would be granted unless defendants within five days reinstated petitioner to his position in the company, with the right to participate in the company's management and free access to the corporation's offices and its books and records.

§ 5.14. *Other squeeze-out techniques*

The circumstances which set the stage for coercion and the methods of applying pressure are so infinitely various that it is impossible to prepare a complete list of squeeze-out techniques. There is even a possibility, for example, of squeezing out a shareholder by paying large dividends, a sort of dividend squeeze in reverse. A favorite squeeze technique, of course, is to withhold dividends.[142] Dean Elvin R. Latty, however, likes to tell of a case where majority shareholders threatened to declare tremendous ("whopping") dividends unless a minority shareholder who was in a high tax bracket sold his interest in the enterprise to them.[143]

The cases show that pressure has been applied or unfair results achieved in a great variety of ways, including the following: refusal of one shareholder-officer in a two-man company to sign the salary checks of the other shareholder who was devoting his full time to managing the business;[144] continuing an inactive mining company in existence so that majority shareholders could utilize its assets for their own benefit;[145] continuing to operate, even though at a loss, one of the company's stores in order to provide lucrative employment for some of the controlling shareholders;[146] operation of an adjacent competing store by company's controlling shareholders;[147] promise by a shareholder who controlled only two members of a four-man board of directors that he would obtain an open line of credit for the corporation if the number of directors were increased to five and he were put on the board and made its chairman;[148] canceling on the books of the company (to destroy evidence

[142] See *supra*, § 3.04.
[143] See Comment, 1959 Duke L. J. 436, 439 n. 16.
[144] *In re* Radom & Neidorff, Inc., 307 N.Y. 1, 119 N.E.2d 563 (1954).
[145] See Riley v. Callahan Mining Co., 28 Idaho 525, 155 Pac. 665, 667 (1916) (allegations not proved). See also Central Standard Life Ins. Co. v. Davis, 10 Ill.2d 566, 141 N.E.2d 45 (1957).
[146] Regenstein v. J. Regenstein Co., 213 Ga. 157, 97 S.E.2d 693 (1957).
[147] *Ibid.*
[148] See Porterfield v. Marden, 88 So.2d 608 (Fla. 1956).

of ownership) shares which holder had pledged as collateral;[149] sale by voting trustees (who had power to sell) of shares in the trust to holders of majority of voting trust certificates to the exclusion of minority certificate holders;[150] retention of the corporation's funds for longer than the necessary or customary period by a majority shareholder or his company acting as the corporation's sales outlet.[151]

Recent cases show that still other squeeze patterns are being evolved. Thus, in a Pennsylvania case,[152] a shareholder in a small corporation took his son's shares from the company safe, marked the certificate canceled, and then issued to himself a new certificate of stock. And, in a California case,[153] a shareholder, in order to persuade one of his colleagues to sell shares to him, led the seller to believe that the corporation was buying the shares and that all shareholders remaining in the corporation would benefit proportionately by the purchase.

A number of ways are open to common shareholders to squeeze preferred shareholders. For example, in some situations, common shareholders planning to dissolve a corporation may cause it to redeem the preferred shares to avoid larger payments to the preferred shareholders on liquidation.[154] In other situations, e.g., if the corporation's capital has been impaired and common shareholders have little equity left in the corporation, common shareholders may launch the corporation on speculative and unwise ventures which subject the preferred to great risks with no possibility of benefit to the preferred but which, by some remote chance, might benefit the common.[155]

[149] See Anderson v. W. J. Dyer & Bro., 94 Minn. 30, 101 N.W. 1061 (1904).

[150] See Jesser v. Mayfair Hotel, 316 S.W.2d 465 (Mo. 1958), where the court enjoined the trustees from transferring the shares on the ground that the trustees owe a duty to all the holders of voting trust certificates and must represent them all and not just the majority certificate holders, and on the ground that the trustees were only empowered to sell all of the stock not just a part thereof.

[151] See Chounis v. Laing, 125 W. Va. 275, 23 S.E.2d 628 (1942).

[152] Thompson v. Curwensville Water Co., 400 Pa. 380, 162 A.2d 198 (1960).

[153] Crane Valley Land Co. v. Bank of America N.T. & S.A., 5 Cal. Rptr. 731 (Dist. Ct. App. 1960).

[154] See Zahn v. Transamerica Corp., 162 F.2d 36 (1947) (the court held that the class B shareholder had breached his fiduciary duty to class A shareholders—really a class of preferred stock—in carrying out this scheme.)

[155] See Towerhill-Connellsville Coke Co. v. Piedmont Coal Co., 33 F.2d 701 (4th Cir. 1929), rehearing denied, 35 F.2d 179, cert. denied, 280 U.S. 607 (1930). See also Central Standard Life Ins. Co. v. Davis, 10 Ill.2d 566, 141 N.E.2d 45 (1957), where plaintiff complained because common shareholders would not liquidate the business, contending that it was apparent that the business could not succeed and that only the holders of the common stock could profit from its continuance. The court,

Whenever dividends on preferred shares are "non-cumulative," (i.e., preferred dividends not declared in one year need not be made up in the following year before dividends can be paid on common shares) common shareholders through their control of the board of directors may cause dividends to be withheld on the preferred even though earned. In most jurisdictions if the directors fail to declare dividends on non-cumulative preferred stock during a particular year the dividends, whether or not they had been earned, are lost.[156]

§ 5.15. *Expanding conception of fiduciary duties of directors and controlling shareholders*

Any of the schemes to squeeze out minority shareholders raise basic questions as to the nature and extent of the duties owed by controlling shareholders, directors, and officers in a corporate enterprise to minority shareholders.[157] In the past some courts have permitted majority shareholders and the directors to exercise almost without restriction the powers they have under the statutes and the corporation's charter and by-laws;[158] they have even treated the fiduciary duties of the directors as running only in favor of the corporation, not to the minority shareholders.[159] This view that the controlling shareholders and the directors do not owe fiduciary duties to minority shareholders is outmoded, at least as applied to squeeze-outs and other attempts to deprive minority shareholders of their proportionate rights without a just equivalent. Where several owners

however, refused to dissolve the corporation, noticing that the record suggested that the company might shortly be in a position to pay dividends on preferred.

[156] New York, L.E. & W.R. Co. v. Nichols, 119 U.S. 296 (1886); Joslin v. Boston & M.R. Co., 274 Mass. 551, 175 N.E. 156 (1931). Contra, Cintas v. American Car & Foundry Co., 131 N.J. Eq. 419, 25 A.2d 418 (1942), aff'd mem., 132 N.J. Eq. 460, 28 A.2d 531 (Ct. Err. & App. 1942); cf. Lich v. United States Rubber Co., 39 F. Supp. 675 (D. N.J.), aff'd mem., 123 F.2d 145 (3d Cir. 1941).

[157] This section is reprinted from O'Neal, Close Corporations: Law and Practice § 8.07 (1958). Published by Callaghan & Company, 6141 N. Cicero Ave., Chicago 46, Illinois. See also Note, "Fiduciary Duties of Majority or Controlling Stockholders," 44 Iowa L. Rev. 734 (1959).

[158] See Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del.), aff'd, 146 F.2d 701 (3d Cir. 1944); McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S.2d 253, 262 (1945); Ballantine, Corporations § 278 (1946); cf. Bodell v. General Gas & Electric Corp., 15 Del. Ch. 420, 140 Atl. 264 (Sup. Ct. 1927), sustaining discretion of the directors in selling no par stock at less than market value.

[159] Carpenter v. Danforth, 52 Barb. 581 (N.Y. Sup. Ct. 1868); Stevens, Corporations § 150 (2d ed. 1949).

carry on an enterprise together, their relationship should be considered a fiduciary one.[160]

The fact that the enterprise is incorporated should not substantially change the picture. True it is, that when businessmen organize a corporation they enter into their relationship against a background of corporation statutes and common law doctrine which vest in the directors the power to manage the corporation's affairs and in the directors and specified percentages of the shareholders power to effect fundamental corporate acts, such as the sale of all the corporation's assets or reorganization of the corporation through merger or consolidation. That does not mean, however, that the directors or the majority shareholders should be permitted to exercise their powers arbitrarily or without regard to the legitimate expectations of the minority shareholders.[161]

Many of the older decisions[162] and practically all of the recent ones[163] indicate that controlling shareholders, in some circumstances at least, owe fiduciary duties to minority shareholders and that the courts will require them (whether they act in their capacity as shareholders or through directors or officers whom they control) to observe accepted standards of business ethics in transactions affecting rights of minority shareholders. In view of the informal way in which the affairs of most close corporations are conducted, there is usually no necessity for distinguishing between the fiduciary duties of the controlling participants in their various capacities as share-

[160] See Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145-46 (1932). In a business operated by a closely knit family, there is of course even stronger reason for imposing a high fiduciary duty on the members of the family in their business dealings with each other. See Samia v. Central Oil Co., 158 N.E.2d 469, 473-74, 476 (Mass. 1959).

[161] In Southern Pacific Co. v. Bogert, 250 U.S. 483, 487-88 (1919), Mr. Justice Brandeis, speaking for the court, in referring to the principle that majority shareholders rule, commented as follows: "The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much as the corporation itself or its officers and directors."

[162] Hyams v. Calumet & Hecla Min. Co., 221 Fed. 529 (6th Cir. 1915); Ervin v. Oregon Ry. & Nav. Co., 27 Fed. 625 (S.D.N.Y. 1886); Allied Chemical & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 1, 120 Atl. 486, 491 (Ch. 1923); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148, 151-52 (1919).

[163] See, e.g., Funk v. Spalding, 74 Ariz. 219, 246 P.2d 184 (1952) (shareholder who took over management of close corporation on departure of other shareholder for military service owes the absent shareholder a fiduciary duty to account for profits, and absent shareholder can maintain in his own right action based on fiduciary relation); Elsbach v. Mulligan, 58 Cal. App.2d 354, 136 P.2d 651 (1943); Mendelsohn v. Breuil Petroleum Corp., 34 Del. Ch. 6, 99 A.2d 236 (Del. Ch. 1953); Mendelsohn v. Leather Mfg. Co., 326 Mass. 226, 93 N.E.2d 537 (1950); Gaines v. Long Mfg. Co., 234 N.C. 340, 67 S.E.2d 350, 234 N.C. 331, 67 S.E.2d 355 (1951); Meadows v. Bradshaw-Diehl, 139 W. Va. 569, 81 S.E.2d 63 (1954); Stevens v. Hale-Haas Corp., 249 Wis. 205, 23 N.W.2d 620 (1946).

holders, directors, and officers. As was said by the Court of Appeals of New York,[164] whenever a number of stockholders "constitute themselves, or are by the law constituted, the managers of corporate affairs or interests, they stand in much the same attitude toward the other or minority stockholders that the directors sustain generally toward all the stockholders, and the law requires of them the utmost good faith," and a court of equity "will protect a minority stockholder against the acts or threatened acts of the board of directors or of the managing stockholders of the corporation, which violate the fiduciary relation and are directly injurious to the stockholders."[165] And, as a federal court has said,[166] majority shareholders "owe to the minority the duty to exercise good faith, care, and diligence to make the property of the corporation in their charge produce the largest possible amount, to protect the interests of the holders of the minority of the stock and to secure and deliver to them their just proportion of the income and of the proceeds of the property. Any sale of the corporate property to themselves, any disposition by them of the corporation or of its property to deprive the minority holders of their just share of it or to get gain for themselves at the expense of the holders of the minority of the stock, becomes a breach of duty and of trust which invokes plenary relief from a court of chancery."

[164] Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148, 151-52 (1919).

[165] Compare language in Allied Chemical & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 1, 120 Atl. 486, 491 (1923).

[166] Jones v. Missouri-Edison Elec. Co., 144 Fed. 765, 771 (8th Cir. 1906). See also Gaines v. Long Mfg. Co., 234 N.C. 340, 67 S.E.2d 350, 353 (1951).

CHAPTER VI. SQUEEZE-OUTS IN PARTNERSHIPS

§ 6.01. *Scope of chapter*

Previous chapters have dealt primarily with corporations. This chapter discusses the techniques used in partnership squeeze-outs. After some introductory comments it sets forth the general principles of partnership law and practice applicable to these problems and discusses whether the various corporate techniques are available in the partnership area.

The basic partnership squeeze-out techniques are the bringing about of dissolution by a partner who is in a strong financial position so that he can purchase the firm's assets and business when it is liquidated; ouster of one partner from the partnership; appropriation of firm assets and property; and appropriation of various partnership opportunities. Somewhat analogous to the corporate technique of utilizing fundamental changes for squeeze-out purposes is the partnership device of incorporation to obtain a setting more favorable to the elimination of undesired participants. Attention is given to all of these as well as to the ancillary technique of withholding information about partnership activities.

§ 6.02. *Partnership amenability to squeeze-outs*

From a practical standpoint, when two or more individuals decide to combine their efforts and enter a business, they usually must choose between conducting the business as a corporation or as a partnership. Their decision is based upon the various actual or supposed advantages of one form over the other,[1] and lawyers or accountants often play a large part in this determination. Were it not for these purported advantages or disadvantages and the advice of legal or business counselors, a substantial number of closely held corporations would probably have been organized as partnerships. Partnerships and small corporations are functionally much alike, and partners are the same types of people as shareholders in small corporations. Partners and shareholders in small companies have the same business and personal problems.

It is therefore not surprising that partnerships, as well as corporations, must often contend with dissension and strife. For various reasons one partner may feel that he alone should manage the enterprise, that he deserves to receive the lion's share of the profits, or that he must act to exclude partially or totally one or more of his co-partners from the business or its proceeds.

A surprising number of cases have been litigated to determine whether the partnership relation existed in particular fact situations.[2] The necessity for this determination is not infrequently to ascertain the technical relationship of the litigants as one step in the process of deciding whether a squeeze-out has been attempted and to fix the rights of the parties.[3] For example, it may be necessary to determine whether one of the litigants actually owed a fiduciary duty to the other in order to decide whether a duty has been breached. Furthermore, one participant in an enterprise may

[1] See O'Neal, Close Corporations: Law and Practice §§ 2.03, 2.04 (1958); Sarner, Organizational Problems of Small Business 1-151 (rev. ed. 1946); Keith, Impact of Taxation on Small Business, 24 Law & Contemp. Prob. 98 (1959).

[2] Some of the cases are collected in Annots., 137 A.L.R. 6 (1942); 150 A.L.R. 1003 (1944).

[3] See, e.g., Nelson v. Abraham, 29 Cal.2d 745, 177 P.2d 931 (1947); Degen v. Brooks, 77 N.D. 494, 43 N.W.2d 755 (1950); Graham v. Street, 109 Utah 180, 166 P.2d 524 (1946); Waagen v. Gerde, 36 Wash.2d 563, 219 P.2d 595 (1950); Mueller v. Sloan, 25 Ill. App.2d 263, 167 N.E.2d 4 (1960); R. C. Gluck & Co. v. Tankel, 199 N.Y.S.2d 12 (Sup. Ct. 1960); Hennessy v. During, 124 N.Y.S.2d 266 (Sup. Ct. 1953); Hasday v. Barocas, 10 Misc.2d 22, 115 N.Y.S.2d 209 (Sup. Ct. 1952).

assert that a partnership exists in order to claim a share of business profits or to participate in gains from the sale of the enterprise or its assets. Conversely, a participant may assert that a partnership does not exist in order to deny an associate any share of the profits or any participation in gains from a sale.

The inherent simplicity of the partnership form results in fewer opportunities (as compared with the corporation) for subtlety or sophisticated dealings in effecting a squeeze-play. Consequently, many partnership squeeze cases involve outright fraud,[4] close approximations to it, or flagrant appropriations of partnership assets or business opportunities. Because of the more highly developed concept of fiduciary duty applied to partnership relations and the ease of dissolution, the partnership is not as amenable as the corporation to some of the squeeze-out techniques. A wide-awake partner, with the aid of timely and competent advice, often can more easily prevent or thwart a squeeze-out than can a corporate shareholder under similar pressure.

§ 6.03. *Nonavailability of some corporate squeeze-out devices*

A partnership is a consensual relationship.[5] The partners are free to mold the management and operation of the business to suit themselves[6] and can make various arangements for distribution of profits. Organizationally, then, a partnership is flexible and can be set up to provide control proportionate to investment, representative management, or concentration of control in one or a few persons. Some partners may be denied any right whatever to participate in

[4] See, e.g., Prince v. Harting, 2 Cal. Rptr. 545 (Ct. App. 1960) (partnership formed for explicit purpose of defrauding copartners).

[5] Uniform Partnership Act § 18 (g). See Lattin, Corporations 5 (1959). The Uniform Partnership Act (hereinafter referred to as U.P.A.) promulgated by the National Conference of Commissioners on Uniform State Laws, has been adopted, as of Nov. 1, 1959, by the following jurisdictions: Alaska, Ariz., Ark., Cal. Colo., Del., Guam, Idaho, Ill., Ind., Ky., Md., Mass., Mich., Minn., Mo., Mont., Neb., Nev., N.J., N.M., N.Y., N.C., N.D., Ohio, Okla., Ore., Pa., R.I., S.C., S.D., Tenn., Utah, Vt., Va., Wash., W. Va., Wis., Wyo. 7 U.L.A. 2, 7 (Supp. 1959). To the effect that the partnership law of Louisiana, a civil law jurisdiction, "is not materially different, at least as interpreted and applied by the Louisiana courts, from the law of other states," see O'Neal, The Louisiana Law of Partnership 8 (1949) (unpublished thesis in Yale Law School Library).

[6] See Crane, Partnership 348 (2d ed 1952). Cf. U.P.A. §§ 18 (e), 18 (h); Nick v. Craig, 301 Pa. 50, 151 A. 573 (1930); Crane, Partnership 276-277 (2d ed. 1952).

management. Although certain control arrangements may subject a partnership to taxation as a corporation,[7] the enterprise remains a partnership for other purposes.

Nevertheless, general partnerships are as a rule formed without utilizing special arrangements that alter basic partnership characteristics; therefore, the typical general partnership, unadorned by special control arrangements, is the type of partnership referred to in this discussion of the nonavailability in partnership squeeze-plays of some of the more popular corporate squeeze-devices.

The inherent characteristics of the partnership form of business preclude many of the popular corporate squeeze-out techniques. Partners ordinarily do not depend on salaries[8] or dividends for a return on their investment but receive a share of the profits of the enterprise.[9] Additionally, a partner, as a co-owner of the business, is entitled to continued employment by the firm. In consequence, there is no partnership counterpart of the corporate squeeze-technique of terminating a shareholder's employment[10] and withholding dividends.[11] Also necessarily eliminated are those techniques dependent upon manipulations of shareholders' and directors' meetings to give one group an advantage over another, such as giving short notice of a meeting, holding it in an inconvenient place, and omitting advance notice of important matters to be discussed.[12] These devices are generally not applicable since partners have equal rights, as individuals, in the management of the business and exercise these rights directly and not through representatives.[13]

There are other techniques based on peculiarities of the corporate form which have no parallel in a partnership. For example,

[7] A partnership with sufficient corporate attributes may be considered an "association" and thus taxed as a corporation. See Int. Rev. Code of 1954 § 7701 (a) (3); Rubin, Associations: Partnerships Taxable as Corporations, 8 La. L. Rev. 313 (1948). See also U.S. v. Kintner, 216 F.2d 418 (9th Cir. 1954).

[8] See Nevarov v. Nevarov, 256 P.2d 330, 333 (Cal. App. 1953); Crane, Partnership 349 (2d ed. 1952).

[9] The reason for this rule has been thus stated: "In the business of a partnership the services of a partner are rendered for the common benefit in the performance of an obligation created by the partnership agreement, and the resultant benefit is divided pro rata as provided in the partnership contract. These profits constitute, in the absence of other agreement, the stipulated reward for services to be rendered, and there is no right to other compensation based on the reasonable value of the services actually rendered." Lehman, J., in Levy v. Leavitt, 257 N.Y. 461, 467, 178 N.E. 758, 760 (1931).

[10] See § 3.05 *supra*. cf. § 3.06 *supra*.

[11] See § 3.04 *supra*.

[12] See § 5.07 *supra*.

[13] U.P.A. § 18 (e).

techniques which require share manipulation cannot be used by partners. Thus, partners cannot issue new stock to dilute minority interests and voting power,[14] or amend the charter to make shares redeemable at the option of the business unit and then cause directors to exercise the power to redeem the stock.[15] Still other devices are also peculiar to the corporation. These include manipulations to eliminate or circumvent cumulative voting rights,[16] and alteration of preferred shareholders' dividend and liquidation preferences.[17]

Since a partnership is primarily a consensual relationship, it can be dissolved at any time by any partner. A partner can force dissolution even though the articles of partnership state that the partnership will operate for a specified length of time.[18] Ease of dissolution avoids in partnerships the injustices caused by those corporate squeeze-plays in which one shareholder excludes another from active participation in the business and yet at the same time, because of the squeezee's inability to dispose of a minority interest at a fair value, forces him to leave his investment in the business.[19]

Partnership dissolution gives a withdrawing partner an immediate right to an accounting.[20] This right, coupled with the ease of dissolution, obviates problems and difficulties present when minority shareholders attempt to dissolve a corporation. Because dissolution of a partnership is comparatively simple, partners do not have to contend with the complexities and problems encountered when dissolution is used in a corporate squeeze-play.[21]

Although the concept of fiduciary duties owed by directors and controlling shareholders to minority shareholders has been widely accepted in recent years,[22] it has not yet been universally accepted in all its vigor in some jurisdictions. And even where fully recognized, fiduciary duties perhaps are still not as strong and pervasive as the fiduciary obligations partners owe to each other. The basic theme of fiduciary duty runs all through the law of partnership. "It

[14] See § 4.14 *supra.*
[15] See § 4.03 *supra.*
[16] See § 5.08 *supra.*
[17] See § 4.04 *supra.*
[18] See U.P.A. § 31 (2). A partner forcing dissolution in spite of stipulations against dissolution may be required to pay damages. See e.g., Williams v. Hildebrand, 200 Ark. 245, 247 S.W.2d 356 (1952). See also U.P.A. §§ 29, 31 (2); Rohrlich. Organizing Corporate and other Business Enterprises 91 (3d ed. 1958).
[19] See § 2.15 *supra.*
[20] U.P.A. § 43.
[21] See § 4.09 *supra.*
[22] See § 5.15 *supra.*

is often said, and rightly so, that a partnership encompasses two relations with respect to which the law is very jealous; namely that of trustee and that of agent."[23]

In discussing the standards applicable to joint venturers, whose intramural fiduciary obligations are akin to those of partners,[24] Mr. Justice Cardozo, then Chief Judge of the New York Court of Appeals, wrote:

> Joint venturers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[25]

Because of the highly developed partnership fiduciary concept and the consensual nature of this relationship, courts readily look into the internal affairs of partnerships. Since courts exercise greater control over the internal operations of partnerships than they do over the affairs of corporations,[26] partners' oppressive acts can be more readily remedied.

Corporate concepts and principles invite the use of rather sophisticated and subtle squeeze-techniques. In corporate squeeze-plays, as many aspects of corporate law are complex and give squeezers plenty of leeway for manipulation, the squeezers can frequently resort to schemes which have an aura of legitimacy. Not uncommonly the squeezers obtain legal advice; thus lawyers quite often become involved in planning or executing corporate squeeze-plays. When a shareholder wants to exclude another he generally has the capacity and desire to adopt techniques which at least purport to be lawful.

Partners often lack opportunity for effective oppression under color of law. Therefore they fall back on cruder methods, frequently

[23] 1 Barrett & Seago, Partners & Partnerships: Law & Taxation 581 (1956).
[24] A joint venture is, in effect, a partnership for a specific transaction.
[25] Meinhard v. Salmon, 249 N.Y. 458, 463-464, 164 N.E. 545, 546 (1928).
[26] See § 3.03 *supra*.

some kind of extralegal activity. Do-it-yourself squeeze-outs are the rule in partnerships; lawyers usually are not consulted by partnership squeezers until their plans have gone awry.

All of this does not mean, however, that there are proportionately fewer partnership than corporate squeeze-plays. The authors of a leading partnership treatise, in discussing the prevalence of squeeze-outs in partnerships, comment as follows:

> The number of cases on this subject both modern and ancient might suggest that it would be well for each partnership to have a liberal supply of framed copies of the Golden Rule so that they might be placed in the offices of all the partners. It may safely be said that unless the Golden Rule is made a working hypothesis of a partnership there will be no diminution in the number of decided cases on this subject.[27]

§ 6.04. *Ouster of a partner from the firm*

The section immediately preceding points out that a partner can dissolve the firm at any time and that this power to dissolve is a protection to a partner against squeeze-out techniques which might be effective against a minority shareholder in an incorporated enterprise. This same ease of dissolution, however, opens up a procedure by which a partner in a strong financial position can eliminate a co-partner from the enterprise. The wealthy partner simply forces dissolution of the firm; and if his co-partner is in financial straits, lacks initiative, or is doubtful of his ability to handle the enterprise by himself, the partner forcing dissolution buys up the firm's assets on its liquidation perhaps at less than their value and continues the business without the undesired party, probably at the same location and perhaps under a business name similar to the firm name. This procedure is frequently used. In many instances, it proves to be unimpeachable.

When one partner excludes another from the physical premises or from participation in the management and profits of the partnership, he thereby completely appropriates the assets and property of the business along with its good will. Perhaps the least sophisticated technique used by one partner to exclude another is to do

[27] 1 Barrett & Seago, Partners & Partnerships: Law & Taxation 576 (1956).

just that—oust him—bluntly and directly. In one case,[28] D told P to hand over his key and "kicked" P out of the business. In another case,[29] D took over the management and control of the business, told P to stay away and not to interfere with the firm's operation, and changed the lock on the door so that P could not enter.

Occasionally, the technique is somewhat less crude. In *Engstrom* v. *Larson*,[30] partners operated a cafe. Engstrom, the manager, left to enter another business and, with Larson's consent, Mrs. Engstrom became manager. When her mother died several months later, Mrs. Engstrom left town for nine days. On her return, the Larsons told her that her husband had been "eliminated" when he left, that she no longer had an interest in the business, and that the cafe was being sold. The Larsons refused to give an accounting and would not share the proceeds of the sale with the Engstroms.[31]

Sometimes an outsider joins with one of the partners to help oust another partner. A Utah case[32] is illustrative. During World War II when construction equipment was difficult to obtain, Graham, a contractor, located a tractor and began making arrangements to purchase it. He and Street, a tractor "skinner," decided to join forces and form a partnership to operate the tractor.

Street then suggested they visit Siegel to obtain financing. After negotiations, Siegel agreed to loan the necessary money, secured by a note and mortgage on the tractor. But when the seller of the tractor tendered a bill of sale in Graham's name, Siegel refused to pay until his own name was substituted as purchaser.

Siegel later denied the existence of the note and mortgage and suggested that Graham, Street, and he form a partnership based on his "ownership" of the tractor. Siegel offered to rent the tractor to the new partnership in return for one third of the profits, but Graham refused to discuss this.

Thereafter, Street and Siegel reached some kind of working agreement, and Street had checks for work performed with the tractor made out exclusively to himself and turned a part of the profits over to Siegel. Street refused to account to Graham for money received and in effect acted as though he and Siegel were the partners.

[28] Dillard v. John Chatmas Wholesale, 286 S.W.2d 675 (Tex. Civ. App. 1956).
[29] Schroer v. Schroer, 248 S.W.2d 617 (Mo. 1952).
[30] 77 N.D. 541, 44 N.W.2d 97 (1950); 79 N.D. 188, 55 N.W.2d 579 (1952).
[31] Compare Nelson v. Abraham, 29 Cal.2d 745, 177 P.2d 931 (1947).
[32] Graham v. Street, 109 Utah 460, 166 P.2d 524 (1946).

Graham brought suit, and the court ordered a partnership accounting for the proceeds accruing from the use of the tractor.[33]

The Uniform Partnership Act grants the right to an accounting to a partner wrongfully excluded from possession of property or from the business of the partnership.[34]

As one court said:

> Where certain of the partners wrongfully exclude another from its [*sic*] business and take unto themselves the assets of the partnership they become, as to the excluded partner, trustees ex maleficio, . . . and are to be held accountable to the excluded partner for his share of the subsequently earned profits.[35]

Exclusion of a partner from participation in a firm's work and management can sometimes be as effective a squeeze-out as his complete ouster.[36] Ordinarily the partnership agreement contemplates participation by each of the partners, and each partner generally feels that he must participate in order to safeguard his investment in the firm and protect his nonpartnership assets against possible liability to creditors in the event of business failure.

Depriving a partner of his right to participate in the operation of a business and to protect his interests as he sees them is a form of squeeze-out. The harm to the individual or to the business resulting from usurpation of his right of control varies in individual cases, but it is clear that the law provides a partner with these rights for good reason. These rights give a partner a vantage point for the exercise of vigilance. One authority, recognizing the harm in this type of squeeze, has written that, "generally, it may be said that nothing is considered as so loudly calling for the interference of the Court between partners, as the improper exclusion of one of them

[33] See Casey v. Grantham, 239 N.C. 121, 79 S.E.2d 735 (1954) (similar squeeze technique also involving participation of a third party lender). Compare Degen v. Brooks, 77 N.D. 514, 43 N.W.2d 755 (1950) (loan used to obtain leverage in attempted squeeze-out). For the effect of one ouster, see N.Y. Times, June 8, 1960, p. 68, col. 1 (city ed.) (physician charged with murder of one of two physician copartners who together had allegedly forced him out of medical partnership after quarrel over finances and purportedly had withheld $5,000 due him).

[34] U.P.A. § 22 (a).

[35] Schroer v. Schroer, 248 S.W.2d 617, 619-20 (Mo. 1952).

[36] See, e.g., Lowengrub v. Meislin, 376 Pa. 463, 103 A.2d 405 (1954); Poole v. Schrichte, 39 Wash.2d 558, 236 P.2d 1044 (1951); Friedland v. Friedland, 148 N.Y.S.2d 328 (Sup. Ct. 1956). In contrast to these cases, not uncommonly one of the partners does not want to work full time though he does want to draw an equal share of the profits. Perhaps this in itself has its squeeze aspects, and may later cause the other partners to squeeze out their lazy copartner.

by the others from taking part in the management of the partnership business."[37]

Sometimes the other members of a firm merely ignore the excluded partner when they make policy or managerial decisions,[38] or they leave him to putter around by himself without assigning him specific duties. Often, however, squeezers take more affirmative steps to prevent participation by other partners. In *Vangel* v. *Vangel,*[39] for example, the defendant managing partner prevented his copartners from putting in equal time in partnership activities, and even from speaking with the employees. He told one partner "to mind his own business and even threatened him with bodily harm if he interfered with the employees."[40]

Stark v. *Reingold,*[41] though illustrative of the concurrent application of several squeeze techniques, particularly demonstrates two: the exclusion of a partner from participation in the management of partnership affairs, and the appropriation of business opportunities. The Stark brothers, Philip and Max, owned Corporation A, a Hudson automobile dealership. Irving Reingold operated a gasoline station, a car rental agency, and a Kaiser-Frazer automobile dealership on land owned by Reingold and his wife Sally.

Philip Stark[42] and the Reingolds decided to combine their activities. They executed agreements having the following effects:

1. They agreed to form Corporation B, which was to engage in automobile sales and in the operation of gasoline and service stations. Philip received fifty per cent and the Reingolds together fifty per cent of the corporate stock, and each shareholder was given an option to purchase at book value the stock of the other shareholder before it could be sold to others. Corporation B eventually became a real estate holding company and ceased its other activities.

[37] Lindley, Partnership 387 (11th ed. 1950). See also Crane, Partnership 348 (2d ed. 1952).

[38] See, e.g., Stark v. Reingold, 18 N.J. 251, 113 A.2d 679 (1955).

[39] 254 P.2d 919 (Cal. App. 1953), rev'd on other grounds, 45 Cal.2d 804, 291 P.2d 25 (1955).

[40] 254 P.2d at 922.

[41] 18 N.J. 251, 113 A.2d 679 (1955).

[42] Max Stark was not included in any of the written agreements. Philip stated, however, that there was an oral agreement that Max would be recognized as a partner with a one-quarter interest in the new ventures. Irving Reingold denied this, and the court refused to recognize the oral agreement, looking only to the written documents. Max did not formally participate in the new business alignment because of difficulties over New York State gambling and bookmaking charges. See Stark v. Livermore, 3 N.J. Super. 94, 65 A.2d 625 (App. Div.), cert. denied, 3 N.J. 365, 70 A.2d 534 (1949).

2. Philip Stark and Irving Reingold formed the Bergen County U-Drive-It auto rental agency, a partnership.

3. Philip and Irving formed Rein Motors, a partnership, to maintain and operate a gasoline station and to purchase and sell automobiles.

4. Both partnership agreements provided that neither party would, without the other's consent, "assign, mortgage, or sell his share in the partnership, or in its capital assets, or property, or enter into any agreement as a result of which any person shall become interested with him in the partnership. . . ."[43]

Even though the businesses were profitable, disputes arose. Irving Reingold was upset over "persistent efforts"[44] of Max Stark to become a partner, although he did permit Philip Stark to transfer one-half of his Corporation B stock to Max. Philip was dissatisfied because of Reingold's assumption of control over partnership affairs. Reingold made major policy changes and discharged key employees without consulting Stark; Reingold said that he considered himself more capable than Stark.

In an unsuccessful attempt to eliminate the Starks by forcing them to sell out, Reingold "sought the intervention of . . . a notorious gangster and racketeer."[45] After frustrating Max Stark's attempt to acquire U-Drive-It franchises in other New Jersey localities, Reingold then acquired the same franchises for himself through corporations (ostensibly owned by his wife) which he obviously controlled. Although these newly franchised companies were competing with the partnership because of their geographic contiguity, the Reingolds did not offer Philip Stark an interest in them.

Later, Philip and Max Stark secretly agreed that Philip would hold one-half of his partnership interests for Max's benefit, and that Philip would not "complete any extraordinary business transaction in the ordinary course of the conduct of the . . . businesses without first consulting" Max.[46] Soon thereafter they canceled this agreement, apparently on the advice of Philip's attorney.

All these difficulties reached the courts when Philip Stark filed

[43] 18 N.J. at 255, 113 A.2d at 681.
[44] *Id.* at 257, 113 A.2d at 682.
[45] *Id.* at 259, 113 A.2d at 683.
[46] *Id.* at 257, 113 A.2d at 682.

a complaint asking dissolution of the partnerships because of Reingold's alleged misconduct. Reingold counterclaimed, seeking a declaration that Stark's action constituted notice of retirement and that Reingold was therefore entitled to purchase Stark's interest in the partnerships.

The Chancery Court granted dissolution and allowed Reingold to purchase Stark's partnership interest. The New Jersey Supreme Court unanimously reversed that decision. It noted that the partners had agreed to devote their entire time and effort to the partnerships and that Reingold disregarded this agreement and violated his fiduciary obligations when he acquired the new agency franchises. The court also found that the short-lived compact between the Stark brothers effecting the partial assignment of Philip's partnership interests was violative of the agreements. However the court indicated that Philip disrupted the business most when he continued to insist that his brother participate, and that Philip "should clearly have taken steps toward the complete withdrawal of his brother from the business as soon as Max appeared to be a disruptive factor."[47]

The court was convinced that it should grant dissolution of the partnerships; it also felt that it should not permit Reingold, because of his "serious misconduct," to continue the businesses, notwithstanding their continued prosperity. In the light of all the circumstances, the court dissolved the partnerships and liquidated their affairs.

Dissolution of the partnerships was not viewed as an adequate remedy, however; the court also ordered Corporation B dissolved. Applying the New Jersey dissolution-on-deadlock statute,[48] and observing that "the relations between the Starks and Reingolds have been too seriously breached to suggest future agreement and decent corporate operation,"[49] the court used its equity powers to wind up the corporation, and thus completed the dissolution of the Stark-Reingold ventures.

[47] *Id.* at 262, 113 A.2d at 685.

[48] N.J. Stat. Ann. § 14:13-15 (Supp. 1960): "Every corporation . . . may be dissolved . . . when it is made to appear that the corporation has an even number of directors who are equally divided respecting the management of its affairs, and that the voting shares of such corporation are equally divided into two independent ownerships or interests. . . ." The court noted that Stark had testified that he and Reingold "could not agree on anything." 18 N.J. at 264, 113 A.2d at 686.

[49] 18 N.J. at 266, 113 A.2d at 686-87.

§ 6.05. *Appropriation of partnership assets and property*

Not uncommonly a partner will appropriate firm assets or property or take more than his ratable share of partnership proceeds. In one case, a managing partner, by concealing information and through other activities, consistently drew more than his pro rata share of the partnership earnings and succeeded in appropriating over $225,000.[50] In another case,[51] a partner exerted undue influence over his copartner and managed to obtain the assets of the business as a "gift." Also illustrative of appropriation of partnership assets is the situation in which, after dissolution of the partnership, some of the former partners wrongfully continue to operate the business under its original name without paying for this privilege, thus appropriating good will, a firm asset.[52]

One interesting case involved a partner who not only attempted to squeeze out his copartner, but also tried to separate the beneficiaries of an estate from their inheritance.[53] After defendant took over the family business as administrator of his father's estate, he continued to operate it in partnership with his brother. Defendant dominated the business. He made entries in the books and records which indicated that he had made large loans to the business, and then he repaid the loans to himself. Whether there actually ever were any loans is uncertain, and even if there were, allegations were made that the money loaned to the business consisted of partnership funds which defendant had withdrawn without authority.

Later, during his brother's fatal illness, defendant sold much of his brother's property and shuffled large sums of money through their joint account into his own bank account. When his brother died, defendant claimed all of the business property as an asset of the partnership rather than as part of his father's estate. The court

[50] See Blough, Accounting and Auditing Problems—Responsibility of CPA to all partners of the client, 109 J. Accountancy 77-78 (May 1960). See also allegations in Lowengrub v. Meislin, 376 Pa. 463, 103 A.2d 405 (1954).

[51] Thompson v. Levereau, 79 Cal.App.2d 762, 181 P.2d 21 (1947). Compare Alexander v. Sims, 220 Ark. 643, 249 S.W.2d 832 (1952).

[52] Kennedy v. Yost, 32 Del. Ch. 386, 88 A.2d 297 (1952). Compare Schroer v. Schroer, 248 S.W.2d 617 (Mo. 1952). For an unusual facet of this problem, see Note, Partnership: Accounting: Right of Expelled Partner to Sale of Good Will of Professional Partnership, 11 Cornell L.Q. 256 (1926).

[53] Altschuler v. Altschuler, 410 Ill. 169, 101 N.E.2d 552 (1951).

required defendant to account for the operation of the business and ordered a partition of partnership assets.

Less devious are those situations in which a partner receives money in the course of the business activities and directly misappropriates it or refuses in any way to account for it.[54] In an unusual case,[55] plaintiffs were one of three groups of stockholders who had formed a partnership to operate three corporations. They complained that defendants, without their copartners' consent or knowledge, appropriated $10,000 and purchased a yacht, "and did not so much as ask [plaintiffs] to ride in it," took $2,000 for a trip to Europe, "purchased $600 worth of clothes at a high priced New York Men's Shop and charged them to the partnership as advertising expenses," "purchased a parking lot with partnership funds and took title in the name of a third party," borrowed partnership money and "attempted to hide the fraud," and "doctored the books of the company to disguise or cover up these transactions." Perhaps in retaliation for all of the above, "one of the [plaintiffs] purloined the wife of one of the [defendants]."[56]

Here, the Florida Supreme Court upheld the appointment of a receiver for the partnership and corporations and an order granting liquidation:

> In business relations it is not enough to stay within the bounds of legal technicalities. The ethical aspect of human behavior becomes more important. One might as well contend that sheep and sheep-killing dogs would gambol harmoniously in the same pasture as to suspect that a partnership would run smoothly when confidence, good faith, square dealing and integrity among its members have been destroyed.
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> * * *
>
> The law is settled in this country that a court of equity may appoint a receiver for a business on the showing of bad faith, breach of duty or violation of partnership agreement.[57]

A partner attempting to appropriate partnership property may also sell partnership assets.[58] The prevalence of this practice is commented upon in a recent treatise:

[54] See, e.g., Herslof v. Sharpe, 249 Wis. 600, 24 N.W.2d 600 (1946); Lagares v. Kappas, 82 Cal. App.2d 569, 186 P.2d 471 (1947).
[55] Lieberbaum v. Levine, 54 So.2d 159 (Fla. 1951).
[56] These allegations are set forth at 54 So.2d at 160-61.
[57] *Id.* at 160, 161.
[58] See, e.g., Engstrom v. Larson, 77 N.D. 541, 44 N.W.2d 97 (1950).

A question that is frequently put to the practitioner may be about as follows:

> "My partner has sold a portion of the partnership property; he had no right to do this, and furthermore he sold it for less than it was worth."

Variations of this statement are to be found in cases where a partner has disposed of firm property and applied the proceeds to his personal debts without first obtaining the consent of his other partners.[59]

In some cases partners use partnership tools and equipment in activities unconnected with the business and personally retain the resultant earnings.[60]

In one case[61] plaintiff and defendant formed a fishing partnership and designated defendant to operate the boat. They agreed that shark nets were essential and purchased them. Defendant then charged this purchase to the partnership account and paid for the nets out of fishing proceeds. Defendant rigged the nets, made the partnership pay rental for their use, and later sold the nets, pocketing the proceeds. Although he realized almost $24,000 in profits from this transaction, he nevertheless claimed a loss in it, and attempted to charge the loss to the partnership.

Even more blatant are those cases in which partners notify a copartner that the partnership has gone out of business or has been dissolved, and has been succeeded by a new corporation in which the copartner has no interest.[62] This is no more than an ouster and an appropriation of the assets and property of the partnership, particularly since the excluded partner usually receives little if any cash and no accounting unless he resorts to judicial proceedings.

A wronged partner has several available courses of action when assets and property have been appropriated by his copartners. The Uniform Partnership Act provides that

> Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the . . . conduct . . . of the partnership or from any use by him of its property.[63]

[59] 1 Barrett & Seago, Partners & Partnerships: Law & Taxation 430 (1956).

[60] See, e.g., Powell v. Powell, 181 Ore. 675, 184 P.2d 373 (1947); Bode v. Prettyman, 149 Neb. 179, 30 N.W.2d 627 (1948). Compare Graham v. Street, 109 Utah 460, 166 P.2d 524 (1946).

[61] Waagen v. Gerde, 36 Wash.2d 563, 219 P.2d 595 (1950).

[62] See, e.g., Moseley v. Moseley, 196 F.2d 663 (9th Cir. 1952); Hamilton Company v. Hamilton Tile Corporation, 197 N.Y.S.2d 384 (Sup. Ct. 1960).

[63] U.P.A. § 21 (1).

Where the partnership was formed for the purpose of carrying out a particular transaction or venture, the wronged partner might be able to maintain an action at law for the value of the property misappropriated.[64] Generally, however, in order to obtain redress, an equitable action for an accounting must be commenced.[65] This must usually be coupled with a proceeding for dissolution of the partnership, though an accounting alone may sometimes be granted.[66]

§ 6.06. *Appropriation of partnership opportunities: renewal of leases*

Often one partner will appropriate for himself an opportunity of the partnership to reap some business benefit. When this opportunity legitimately belongs to the partnership, a partner who appropriates it to the exclusion of his copartners violates the general rule holding a partner accountable as a fiduciary for any benefits derived by him from any transaction within the ambit of partnership activity.[67]

Frequently the opportunity of the partnership to continue a present lease on business property is usurped. The leading case is *Meinhard* v. *Salmon*.[68] Salmon leased the Hotel Bristol in New York City for twenty years and agreed to alter the premises for use as a business building. He then entered into a joint venture arrangement with Meinhard, who supplied one-half of the funds necessary to alter, manage, and operate the property. In return, Meinhard was to receive 40 per cent of the net profits for the first five years and 50 per cent for the remaining period. Losses, if any, were to be shared equally. Salmon managed the venture.

Four months before the expiration of the lease, Gerry, the owner of the building and adjacent property, suggested that Salmon lease the entire tract, tear down the existing buildings, and put up one large $3,000,000 building. The rental for the enlarged tract was set

[64] See, e.g., McKee v. Capitol Dairies, 164 Ore. 1, 99 P.2d 1013 (1940); Taylor v. Richman, 395 Pa. 162, 149 A.2d 69 (1959).

[65] See, e.g., Keegan v. Keegan, 194 Minn. 261, 260 N.W. 318 (1935) (dicta).

[66] See Crane, Partnership 387 (2d ed. 1952); U.P.A. §§ 22 (a), 31 (2), 32 (d); 1 Barrett & Seago, Partners & Partnerships: Law & Taxation 633-34 (1956).

[67] See, e.g., Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928); Bakalis v. Bressler, 1 Ill.2d 72, 115 N.E.2d 323 (1953); Boxill v. Boxill, 111 N.Y.S.2d 33 (Sup. Ct. 1952). See also U.P.A. § 21.

[68] 249 N.Y. 458, 164 N.E. 545 (1928).

at approximately seven times the rental in the original lease. Salmon accepted this offer and formed the Midpoint Realty Company, which he owned and controlled. He caused Midpoint to lease the land for twenty years with renewal options for extensions up to a total of eighty years. Salmon personally guaranteed performance of the agreement.

Meinhard did not learn of this project until after the new lease had been executed. He then demanded that the lease be held in trust as an asset of the joint venture and offered to share the obligations incident to the guaranty of performance. Salmon refused and Meinhard brought suit.

The majority of the court, through Chief Judge Cardozo, said that "one partner [particularly a managing partner] may not appropriate to his own use a renewal of a lease, though its term is to begin at the expiration of the partnership,"[69] and, though holding that there was no "conscious purpose to defraud,"[70] decided that Salmon breached his fiduciary duty to Meinhard. Meinhard was awarded a share of the new lease. However, in the alternative, Salmon was given the option of attaching a trust in Meinhard's favor to one-half, less one share, of Salmon's Midpoint Realty stock in order to preserve free alienability of the lease and to continue Salmon as manager of the enterprise. By giving this option to the defendant, the court actually set the stage for a possible future squeeze-out—and therefore did not grant effectual and practicable relief.[71]

Although a partner cannot rightfully appropriate, to the exclusion of his copartners, an opportunity available to the partnership in the course of its business, it is necessary to determine whether the partnership actually had a right to the opportunity.[72] In *Meinhard* v. *Salmon*,[73] a strong dissent written by Judge Andrews, and concurred in by two other judges on the seven-member Court of Appeals, was based on the view that the lease taken by Salmon was not an opportunity of the venture. In support, Judge Andrews cited

[69] *Id.* at 466, 164 N.E. at 547.

[70] *Id.* at 467, 164 N.E. at 548.

[71] See, e.g., the demand for relief in Fortugno v. Hudson Manure Company, 51 N.J. Super. 482, 144 A.2d 207 (1958), noted *infra* at § 6.09.

[72] See, e.g., Latta v. Kilbourn, 150 U.S. 524 (1893); Pearlstein v. Baff, 60 N.Y.S.2d 713 (Sup Ct.), appeal dismissed, 270 App. Div. 1043, 63 N.Y.S.2d 710, amended, 271 App. Div. 834, 65 N.Y.S.2d 851, aff'd, 296 N.Y. 881, 72 N.E.2d 613 (1946); Fouchek v. Janicek, 190 Ore. 251, 263-266, 225 P.2d 783, 789-91 (1950); Powell v. Powell, 181 Ore. 675, 184 P.2d 373 (1948).

[73] 249 N.Y. 458, 472, 164 N.E. 545, 549 (1928).

the great difference in rental and increased duration of the new lease, and concluded that Meinhard did not have a legitimate expectancy upon expiration of the original lease.

A Colorado case,[74] although deciding that the leaseholder did have an expectancy of renewal, held that in any event the new lessor had sufficiently disassociated himself from the business and therefore was no longer subject to a fiduciary obligation. There, plaintiff retired from a three-man partnership and sold his interest to the remaining partners. Two years later, after the business had become a one-man corporation owned almost entirely by defendant, plaintiff acquired its premises and refused to renew the lease. When defendant refused to vacate, plaintiff commenced a forcible entry and detainer action. The court held that the plaintiff was not precluded from acquiring title to the premises and should not be compelled to renew the lease, saying that it could not permit defendant's expectancy of renewal to interfere with the right of a landlord to select his tenant.

The problem, then, is one of weighing the following factors: the source of the opportunity; the firm's capacity to utilize it; whether the opportunity is within the scope of the partnership's business; the degree to which the partner's personal utilization of the opportunity places him in actual competition or rivalry with his firm; and the means used by the partner to accomplish his purpose.

Thus in one case[75] plaintiff and defendant together with Corporation A were shareholders in a baking company. Corporation A, the original owner of the baking company, had leased the building to the company and had turned over the operation of the business to plaintiff and defendant. The lease provided that the lessor would have the right to take over the business if the lessee should fail to renew the lease at its expiration.

At defendant's suggestion, the baking company was dissolved, and plaintiff and defendant formed a partnership as equal partners. Corporation A then surrendered its preferred stock in the baking company in return for a partnership note, and the partnership assumed the lease.

Defendant persuaded plaintiff to agree to immediate payment of the note. He argued that interest could be saved, and also con-

[74] Stone v. Lerner, 118 Colo. 445, 195 P.2d 964 (1948).
[75] Bakalis v. Bressler, 1 Ill.2d 72, 115 N.E.2d 323 (1953).

tended that payment of the note might induce Corporation A to sell the property to the partnership. After he paid the note, defendant told plaintiff that Corporation A refused to sell the building. Defendant, however, had actually refused to pay the amount due to Corporation A until he received a signed contract for the purchase of the building. As soon as the building was conveyed to defendant, he deeded it to his wife.

Almost a year later, plaintiff discovered this duplicity and brought suit. The court held that the opportunity to lease realty necessary to the operation and good will of the business was a partnership asset, and that appropriation of this asset by one partner to the exclusion of the others was a violation of the partner's fiduciary duty.

In these cases involving appropriation of a partnership's expectancy to renew existing leases, the courts generally declare a constructive trust of the leasehold for the benefit of the partnership and require the partnership to pay its proportionate share of the expenses undertaken by the appropriating partner. Additionally, on proper application, the court may grant an accounting and decree dissolution of the partnership.[76]

§ 6.07. *Appropriation of partnership opportunities: business propositions*

Not infrequently partners appropriate business opportunities originally offered the partnership. In one such case[77] the partnership conducted a wholesale-retail sporting goods and war surplus business. Hickok, a bank officer and agent for undisclosed investors, presented the partners with an opportunity to enter into a joint venture for activity in the war surplus market. They accepted.

Soon after, partner J visited Hickok at the bank, ostensibly to discuss a personal loan. J told him that he wanted to enter the war surplus business, that the situation in the partnership was such that he "couldn't see continuing on with it" and that he "wanted to break away and set up" for himself. After several similar meetings, Hickok began to lose confidence in the partnership and eventually

[76] See Boxill v. Boxill, 111 N.Y.S.2d 33 (Sup. Ct. 1952); Smith v. Bolin, 261 S.W.2d 352 (Tex Civ. App. 1953), aff'd in part, rev'd in part, 153 Tex. 486, 271 S.W.2d 93 (1954).

[77] Fouchek v. Janicek, 190 Ore. 251, 225 P.2d 783 (1950).

offered J the proposition previously made to all the partners.[78] Presented these facts, the court ordered an accounting, finding that J breached a fiduciary duty by inducing the offer and accepting it.

Appropriation of a partnership opportunity can take various other guises. In *Karle* v. *Seder*,[79] after relations between the partners had become so seriously strained that neither would speak to the other except when necessitated by the exigencies of business, the partners listed their tavern for sale with a real estate brokerage agency. Eventually, prospective purchasers became interested and executed an agreement with the brokers to purchase the tavern for $25,000 *plus* the value of the inventory, later appraised at $1,726.07. Defendant partner then presented a similar agreement to plaintiff partner, who was unaware of the prior negotiations. In this instrument, the name of the purchaser was left blank, and the price for the sale of the tavern was set as $20,000 *including* the value of the inventory. As defendant told plaintiff that if he did not execute the agreement, the deal would be off, plaintiff signed it. Defendant inserted his own name in this agreement as purchaser, and later as sole owner of the business transferred it under the original agreement, realizing a personal profit of $6,726.05 on the transaction.[80] The court affirmed an award for damages for constructive fraud.

In a recent case[81] defendant contemplated an overseas trip to purchase stamps. Plaintiff agreed that if defendant arranged an acceptable deal, he was ready and willing to enter a joint venture. Defendant in his own name and without consulting plaintiff bought certain stamps, agreeing to pick up one lot of the stamps at a New York bank each month for ten months. In the event of default, a deposit which defendant had put up was to be forfeited.

After his return from Europe, defendant got in touch with plaintiff and the parties met. At that time defendant showed plaintiff a written document (purporting to be an agreement to purchase

[78] *Id.* at 269, 225 P.2d at 791. Compare Elsbach v. Mulligan, 58 Cal. App.2d 354, 136 P.2d 651 (1943).

[79] 35 Wash.2d 542, 214 P.2d 684 (1950).

[80] See also Finn v. Young, 46 Wash. 74, 89 Pac. 400 (1907). "I have known of . . . [a] squeeze-out in a manufacturing company, where there was disagreement between partners, first due to methods of management, but mostly the partner attempting to squeeze was interested in removing the other partner, because partner number one had designs on selling the company out at a very substantial profit over what he had to pay his partner, although the partner was paid liberally and fairly." Letter from a Philadelphia businessman dated May 5, 1960. (Name withheld to preserve anonymity of the parties.)

[81] R. C. Gluck & Co. v. Tankel, 199 N.Y.S.2d 12 (Sup. Ct. 1960).

stamps) which listed the price of the stamps at an amount double the real cost to defendant. Concluding that at the cost figure given by defendant a 30 to 40 per cent profit could be realized, plaintiff agreed to become a joint venturer with defendant. They jointly borrowed money. Plaintiff then turned over his share to defendant, who pocketed it. Although defendant told plaintiff that "there was no compelling necessity for meticulous compliance with the conditions of the Russian deal,"[82] defendant later informed plaintiff that, because of his delay in making further payments, the deposit had been forfeited and the deal lost.

Subsequently, without telling plaintiff, defendant withdrew the stamps and sold them at a profit. Similar action was taken in several other instances, "so that what started out as a single deal soon blossomed into a triple deal studded with 'double deals.'"[83] Here, although arguably the joint venture did not commence until plaintiff evaluated the situation and accepted the arrangement, the court held that defendant had a duty of full disclosure at all stages of the negotiations and that he could not treat the arrangement as "an out-and-out sale from defendant to plaintiff and defendant as co-adventurers."[84] The court characterized defendant's actions as fraudulent and ordered him to account for his secret profits.

§ 6.08. *Appropriation of partnership opportunities: diversion to other businesses*

Sometimes a partner will divert firm profits and opportunities to a business he individually owns, thus excluding his copartners. Such a diversion is of course violative of the duty of good faith which a partner owes his copartners.

In a recent case[85] plaintiffs and defendants formed a partnership, The Hamilton Company, to import plumbing supplies, tile, and similar materials into the United States for resale. Within a year the partners were embroiled in strife and dissension. Defendants, together with outsiders, surreptitiously formed a corporation, Hamilton Tile Corporation, to take advantage of the partnership's pre-

[82] *Id.* at 16.
[83] *Id.* at 17 (emphasis omitted).
[84] *Id.* at 18.
[85] Hamilton Co. v. Hamilton Tile Corp, 197 N.Y.S.2d 384 (Sup. Ct. 1960).

viously developed business prospects. Plaintiff claimed that "it was the intent of the corporate group to euchre the partnership out of the profits about to be realized from the importations. . . ."[86] Defendants then informed plaintiffs that the partnership was "dissolved."

In operating the partnership, the partners had found it necessary to factor their imports through a local commercial financing company. The factors, put on notice that there had been a "falling out" among the partners, notified them that specified shipments of merchandise were to arrive in New York, that payment would be due on arrival, and that if payment was not received the shipping documents would be sold. The factors sold the documents when payment was not immediately received; ultimately the documents were purchased by the Hamilton Tile Corporation which resold the merchandise to (among others) customers who had originally ordered the same material from the partnership. Deciding that defendants' concealed purpose was to deflect profits from the partnership to themselves, the court directed defendants to account for their "improper profits."

In *Schroer* v. *Schroer*,[87] defendant took over all management and control of a partnership, Schroer Brothers Machine Works. He constructed a partition through the bulding occupied by the shop and began to conduct a second business of his own, Schroer & Co., on one side of the building. Defendant changed the lock on the only door in the building so that his partner could not enter.[88] He operated each shop as a completely separate business, with its own equipment and power lines and employed fifteen men in each shop. Separate records were kept of the time spent in each shop.

Schroer & Co. took customers and business from Schroer Brothers, and subcontracted the work back to Schroer Brothers. Eventually Schroer & Co. was the only customer Schroer Brothers had. All profits were siphoned off to defendant through Schroer & Co. Here, too, the court decreed an accounting and dissolution.[89]

Waldor v. *Bruey*[90] presents a slightly different aspect of the same basic problem. Two partners, each with a one-half interest, owned

[86] *Id.* at 386.

[87] 248 S.W.2d 617 (Mo. 1952).

[88] See also Schwartz v. Cimaglia, 324 Ill. App. 527, 58 N.E.2d 469 (1944) (partner locked out of factory).

[89] See also, Riss & Co. v. Feldman, 79 A.2d 566 (D.C. Mun. App. 1951). Compare Young v. Cooper, 203 S.W.2d 376 (Tenn. Ct. App. 1947).

[90] 24 N.J. Misc. 354, 49 A.2d 151 (1946), aff'd, 139 N.J.Eq. 238, 50 A.2d 646 (1947).

the business. B was executive manager with "full and complete authority in all matters of policy and in the conduct of the business of the copartnership." The partnership agreement provided that another concern, wholly owned by B, would perform all secondary tool work for the firm at the rate of seven and one-half cents per unit, though this work could be done on the open market for five cents a unit. Not satisfied with this additional profit, B exercised his authority as executive manager and charged ten and one-quarter cents, thus milking the partnership of $83,000.

B had also agreed to rent a machine to the partnership at a specified rental. He then charged double that amount. The court ordered a receiver appointed and an accounting, directing that B's misappropriations be deducted from his share of subsequent business profits.

§ 6.09. *Incorporation of firm as precursor of squeeze-play*

The corporation, as previously suggested,[91] is more amenable than the partnership to many of the more imaginative and successful squeeze-out devices. Recognizing this corporate "attribute," many potential squeezers induce their copartners, under the guise of purported business or tax advantages, to convert a partnership to a corporation. Once the corporation has been organized, the squeezers begin to try to eliminate the undesired participants. In other words, incorporation is utilized as the first of several steps in the process of exclusion.

The facts in a recent case[92] leave little doubt that the corporate form was adopted for squeeze-out purposes. The corporation involved in that case had originally been a sole proprietorship owned by the petitioner, Patton. In 1940 he assigned a 10 per cent interest in the profits to each of the two respondents, then young employees. In 1943 this interest was increased to 20 per cent. The next year Patton attempted to revoke this arrangement, but respondents contended that they were partners in the business and, therefore, that Patton was unable to merely 'revoke' their status.

[91] See § 6.03 *supra*.
[92] Patton v. Nicholas, 154 Tex. 385, 279 S.W.2d 848 (1955).

Hostility continued until 1945, when the parties executed a written settlement which included a provision that the business be incorporated. There were no provisions insuring employment or directorial status to the respondents beyond the first year of corporate operation. Within a few days after incorporation, Patton resumed hostilities.

By lengthy letters, of which he circulated copies among employees below the status of . . . the respondents, the petitioner, speaking for the most part in the first person and as if his words were that of the corporation, indicted the respondents both for "reports" of their bad habits of a personal nature and for any number of stated sins of omission and commission, many of them of a quite petty character, in connection with their work. These were supplemented with verbal admonitions of similar character in the presence of relatively subordinate employees.[93]

Respondents correctly assumed that Patton's actions indicated that their tenure with the company was limited. They therefore resigned.

Before incorporation the business was highly successful and the profits distributed frequently. After that time net earnings declined sharply, though the business outlook remained as before. Dividends were not paid although the net worth steadily increased and the surplus increased from zero to $130,000. Patton's salary was substantially increased until it was almost three times his salary at incorporation.

Soon after respondents left, Patton wrote a letter which indicated that at the time of incorporation "he intended to use his power as majority stockholder arbitrarily to the prejudice of the respondent."[94] "There was also evidence of a declaration by him that he would not buy the stock of respondents for even a small fraction of its value or sell his own at any price."[95]

The court, in discussing the 1945 settlement providing for incorporation, commented that

The respondents obviously were well advised as to the limited extent of their powers as minority stockholders under the new arrangement as distinguished from the powers enjoyed by members of a partnership.[96]

However, the court must have credited the respondents with receiving more or better advice than they actually received. It is

[93] *Id.* at 388, 279 S.W.2d at 850.
[94] *Id.* at 390, 279 S.W.2d at 851.
[95] *Id.* at 390, 279 S.W.2d at 852.
[96] *Id.* at 388, 279 S.W.2d at 850.

hardly conceivable that respondents would have agreed to incorporation if the tremendous squeeze-play potential of the corporate form had been thoroughly explained to them.

The court held that the minority stockholders, though not entitled to liquidation of the corporation, were entitled to some relief. Because Patton breached his trust when he maliciously suppressed dividends, the court granted an injunction requiring the corporation and its majority stockholder, as dominant officer, to declare and pay a reasonable dividend on the stock and ordered that reasonable dividends be paid annually in the future, "provided only that the payment of such dividends be not clearly inconsistent with good business practice."[97]

The court expressly retained continuing jurisdiction of the case and provided that if, in the event of violation of the injunction or upon motion of either of the respondents, and due hearing,

> it shall be determined that the corporation has been in any manner operated with bad faith toward the decree or toward the respondents . . . in their position of minority stockholders, the court shall without prejudice to its additional right to punish for contempt, forthwith appoint a receiver of the corporation, with instructions to liquidate it. . . .[98]

In a Kentucky case[99] plaintiffs and defendants as partners operated a bus line. Defendants sold the Greyhound Bus Company an option to buy 60 per cent of the stock of the bus line in the event of its incorporation. Concealing the arrangement with Greyhound, defendants then induced plaintiffs to incorporate. Plaintiffs would incorporate only on condition that defendants agree not to sell their stock without obtaining for plaintiffs the right to sell their corporate interest on the same terms and conditions. In spite of the arrangement with Greyhound, defendant agreed to the organization of the corporation on that basis.

Greyhound later forfeited the option fee of $37,500. Learning of the option arrangement, plaintiffs sued for a share of the forfeited option fee, contending that they were fraudulently induced to incorporate. The court held that plaintiffs were entitled to share the fee by virtue of the fiduciary duties defendant owed them under the original partnership relationship.

[97] *Id.* at 399, 279 S.W.2d at 857.
[98] *Id.* at 399, 279 S.W.2d at 857-58.
[99] Van Hooser v. Keenon, 271 S.W.2d 270 (Ky. 1954).

In *Fortugno* v. *Hudson Manure Co.,*[100] after a period of conflict and dissension among the partners, the managing partner incorporated various parts of the business, had the stock issued to himself and his nominees, withdrew money from the partnership, purchased land in the name of the corporation which the partnership had intended to buy for itself, and placed partnership contracts in the corporate name. Within a few months the partnership "had ceased to operate and was in effect an empty shell. . . ."[101] In fact, it had become a holding company for the corporate enterprises.

In the meantime, another partner commenced an action for an accounting and dissolution. In opposition to a suggested distribution to him of his proportionate share of stock in each of the corporations upon dissolution of the partnership, the dissident partner argued that he was entitled to payment in cash. He contended that if he was paid in stock, he would not have an effective voice in the policies and operation of the business and would merely be a minority stockholder in each of several corporations. He then would not have obtained effective dissolution of the partnership.

The court ordered (1) that the partnership and all of the corporations be liquidated, and the proceeds distributed in cash; or in the alternative, (2) that the partners remaining with the business have the assets appraised under court supervision and pay the retiring partner his proportionate share of the value of the combined enterprises. The court thus treated the assets of each corporation as partnership property.[102]

§ 6.10. *Denying access to books and records—withholding information*

When partners decide to squeeze out their copartners, they frequently combine with whatever other devices they use the additional technique of denying their copartners access to records and

[100] 51 N.J. Super. 482, 144 A.2d 207 (1958).

[101] *Id.* at 495, 144 A.2d at 214.

[102] For other cases in which the courts disregarded the corporate entity and dissolved or liquidated a partnership-owned corporation, see Lieberbaum v. Levine, 54 So.2d 159 (Fla. 1951); Stark v. Reingold, 18 N.J. 251, 113 A.2d 679 (1955). Compare Hennessy v. During, 124 N.Y.S.2d 266 (Sup. Ct. 1953). But see Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928).

reports.[103] This is done of course in order to conceal unlawful acts and other squeeze-out activities.

In one case,[104] a partner was characterized as "reluctant or slow in making full disclosure of his doings to his partners; he was wanting in spontaneous candor; he was indiscreet and created natural suspicion and distrust in the minds of his partners."[105] In another case, after a managing partner had taken excessive salaries amounting to over $225,000, he withdrew from the previously prepared income tax returns (before showing the returns to his copartners) the schedules which showed partners' drawings and capital balances.[106]

Indirect withholding of information was charged in a recent Montana case.[107] There, plaintiff alleged that, after being called into the armed forces, "defendant installed a system of bookkeeping which plaintiff did not understand and though he was on furlough and returned . . . on three occasions during his military service and tried to examine the books, he could not understand them."[108] Defendant also used more direct methods, making misrepresentations as to the profits of the business and causing false entries to be made in the books to indicate high expenses and reduce the partnership's apparent profits and net worth.

In a California case[109] the squeezers were charged with diminishing the business assets, refusing to account for business receipts, and appropriating property from the partnership. To conceal these activities, one of the squeezers "hired and directed the bookkeeper, wrote the checks, did the banking and in general kept the records, such as they were, and the finances of the business pretty much under his own control. He disclosed but little information concerning the financial condition to the other partners."[110]

Partners may falsify partnership records in order to create false impressions and thus withhold *correct* information from the other participants. This is closely related to overt denial of information. Thus complainants in one case[111] alleged that their partners "doc-

[103] See, e.g., Schroer v. Schroer, 248 S.W.2d 617 (Mo. 1952); Casey v. Grantham, 239 N.C. 121, 79 S.E.2d 735 (1954); Dillard v. John Chatmas Wholesale, 286 S.W.2d 675 (Tex. Civ. App. 1956).

[104] Ferrick v. Barry, 320 Mass. 217, 68 N.E.2d 690 (1946).

[105] *Id.* at 220, 68 N.E.2d at 693.

[106] Blough, Accounting and Auditing Problems, 109 J. Accountancy 77-78 (1960).

[107] Brownback v. Nelson, 122 Mont. 525, 206 P.2d 1017 (1949).

[108] *Id.* at 527, 206 P.2d at 1018.

[109] Lagares v. Kappas, 82 Cal. App.2d 569, 186 P.2d 471 (1947).

[110] *Id.* at 574, 186 P.2d at 475.

[111] Lieberbaum v. Levine, 54 So.2d 159 (Fla. 1951).

tored" the books in order to cover up their appropriative activities. In another case[112] plaintiff complained that his copartners and their accountant conspired to defraud plaintiff of his true interest in the business and that "they implemented and effectuated this by causing a false balance sheet to be prepared."[113]

Adequate and correct information is important if a partner is to protect his rights and prevent action designed to divest him of his interest in the partnership or its profits. Because of this and the presence of a considerable risk of personal liability in partnership transactions, the provisions of the Uniform Partnership Act relating to the accessibility of information serve as valuable reminders of partners' informational duties. The Act provides that partners shall always have access to the partnership books and may at any time inspect and copy them.[114] Additionally, partners are required to give to any partner, on demand, "true and full information of all things affecting the partnership."[115]

A partner may obtain an injunction to prevent his partners from denying access to the books and records of the partnership.[116] The giving of fraudulent or misleading information may be the basis of a suit for damages for deceit.[117] Furthermore, as withholding information or giving misleading or fraudulent information is a violation of the fiduciary duty owed one partner by another, it may be cause for dissolution of the partnership and an accounting.[118]

[112] Greenspan v. Greenspan, 129 N.Y.S.2d 258 (Sup. Ct. 1954).
[113] *Id.* at 260. Compare Brownback v. Nelson, 122 Mont. 525, 206 P.2d 1017 (1949).
[114] U.P.A. § 19.
[115] U.P.A. § 20.
[116] Mechem, Partnership 200 (2d ed. 1920).
[117] See, e.g., Poss v. Gottlieb, 193 N.Y. Supp. 418 (Sup. Ct. 1922).
[118] U.P.A. §§ 21, 31 (6), 32. Cf. Alexander v. Sims, 220 Ark. 643, 249 S.W.2d 832 (1952); Biagi v. Gregory, 19 Ill.App.2d 534, 154 N.E.2d 849 (1959).

CHAPTER VII. ARRANGEMENTS WHICH AVOID SQUEEZE-OUTS

§ 7.01. *Scope of chapter*

This chapter discusses in a summary fashion measures which can be taken (at the time a business is being organized or before friction among the participants has developed) to avoid squeeze-plays and oppression of minority shareholders. Arrangements discussed here are those which can be serviceable under existing law. No attempt is made in this chapter to recommend legislation or other legal changes which might make planning against squeeze-outs easier or more effective.

Attention is first given to ways of avoiding the dissension and conflicts of interest which set the stage for squeeze-plays. Emphasis is placed on the high desirability of a careful study of the underlying causes of squeeze-outs, of comprehensive planning to eliminate as many of those causes as possible, and of providing for the expeditious settlement of whatever disputes develop.

This chapter then discusses arrangements which give affirmative protection to minority shareholders against squeeze-plays. Most prominent among the devices considered are shareholders' agreements, long-term employment contracts, and charter or by-law provisions requiring high votes for shareholder and director action. Finally, a section is devoted to arrangements which are useful in protecting against squeeze-out in partnerships.

§ 7.02. *Careful study of underlying causes of squeeze-outs*

Persons organizing a business enterprise invariably have some conflicting interests; ideally, whenever a participant is to occupy a minority position in an enterprise, his lawyer should carefully study the underlying causes of squeeze-outs discussed in Chapter II. Even the most experienced practitioner might do well to review the recurring problem-situations there discussed before tackling the task of protecting his client in the particular venture on which he is about to embark.

Chapter II, it will be recalled, contains a number of suggestions for avoiding situations which give rise to squeeze-outs. The suggestion is made, for instance, that clear-cut retirement, disability and deferred compensation arrangements might help solve the problem of the aged founder who "hangs on."[1]

A study of the underlying causes of squeeze-outs discussed in Chapter II, however, undoubtedly would suggest to a perceptive lawyer measures other than the ones which are set forth in that chapter. He may, for instance, in order to avoid the dissension which usually develops after a participant in an enterprise buys an interest in a competing business, persuade the participants to include in their business bargain a stipulation against any participant's acquiring an interest in a competing business. Moreover, if the enterprise is to be conducted in the corporate form, the lawyer probably will want to place restrictions on the transferability of the corporation's shares to help prevent shares from getting into the hands of persons who would not take an active part in conducting the business or who would be uncongenial or inclined to indulge in squeeze-plays.

[1] See § 2.05, *supra*.

§ 7.03. *Buy-out arrangements*

As was pointed out in Chapter II, trouble quite frequently develops in a small corporation when its shares pass into the hands of an inactive shareholder,[2] especially to the widow of one of the key participants.[3] An obvious answer to the inactive widow problem is a buy-out arrangement under which the shares of a holder who dies are purchased by the corporation or the other shareholders. Stock-purchase agreements (providing for purchase by the corporation) and buy-and-sell agreements (providing for purchase by the other shareholders) are now widely used.[4] Similar agreements can provide for the purchase of the shares of the holder who reaches retirement age, becomes disabled, or for other reasons ceases to devote substantially full time to the operation of the business.[5] Agreements of this kind should be made in advance while all the shareholders are still active in the business; after a shareholder dies or becomes inactive, negotiations for the purchase of his shares will often be unsuccessful.[6]

§ 7.04. *Arrangements for settling disputes*

Often a squeeze-play can be avoided by setting up in advance by charter or by-law provision or by shareholders' agreement an arrangement to resolve whatever policy disagreements or other disputes arise from time to time among participants in an enterprise. Three approaches seem promising. One is an arrangement by which im-

[2] See § 2.03, *supra*.

[3] In commenting upon Krall v. Krall, 141 Conn. 325, 106 A.2d 165 (1954), which involved a dispute between a widow and the surviving shareholder of a two-man company, a New England attorney of wide experience stated: "This fact situation I have seen repeated many times, usually precipitated by the death of one of the active parties and the intrusion of an inexperienced and quite often suspicious widow into the picture. Obviously, the insured buy-sell agreement is often a convenient device to forestall this type of problem." Letter from Donald F. Keefe, of New Haven, Connecticut, dated Sept. 21, 1959.

[4] Of the tremendous amount of literature on buy-and-sell agreements and other buy-out arrangements the following is perhaps a fair sample: Ackerman, Corporate and Partnership Buy and Sell Agreements, in Advising California Business Enterprises (California Practice No. 9, 1958); Mannheimer, Insurance to Fund Stock Retirement and Buy-and-Sell Agreements, 29 Taxes 393 (1951); Murphy, Survivor-Purchase Stock Agreements, Prac. Law., Nov. 1955, p. 44.

[5] See Mannheimer and Friedman, Buy-Out Agreements (Some Unexplored Aspects of Business Purchase Agreements), 91 Trusts & Estates 16 (1952).

[6] See, e.g., *In re* Radom & Neidorff, Inc., 307 N.Y. 1, 119 N.E.2d 563 (1954).

partial outsiders will be brought in to manage the business until tempers have cooled or the parties have resolved their differences. Another approach is to provide in advance for the arbitration of whatever disputes arise. In jurisdictions in which agreements to arbitrate future disputes (including disputes on management and policy questions) will be enforced,[7] arbitration has great potential for settling quickly and satisfactorily many of the disputes which occur in small businesses and thus avoiding the long drawn-out dissension which leads to so many squeeze-plays.[8]

The third approach is to set up an arrangement under which one faction of shareholders will buy out the interest of the other in the event a dispute persists for a specified period of time. A provision, for example, might require the majority shareholder in a two-man company to buy out the minority shareholder at a specified price, if for a period of two years the two failed to agree on successors for members of the board of directors. An arrangement which is becoming rather popular provides that any shareholder shall have the right to dissolve the corporation at any time but that, before exercising the right to dissolve, a shareholder must first offer his shares to the other shareholders at a specified price or at a price to be determined by formula.

In a two-man company where the shares are evenly divided, the two shareholders sometimes enter into an agreement which provides that either shareholder may at any time set a price which he is willing to take for his interest in the business or to give for the other's interest and that the other will then have a specified period of time to decide whether he will buy or sell at that price. No instance has been found where an arrangement of this kind has been used in a company in which one shareholder owned more than half the stock; nevertheless, no reason is apparent why the shareholders in such a company could not use this type of buy-out. The price, instead of being stated in terms of a half-interest in the business, would have to be set at so-much-per-share. A possible objection is that the price a majority shareholder would receive for his majority interest, if he

[7] For a decision holding that only controversies "which may be the subject of an action" may be contracted to be decided by arbitration, see Application of Burkin, 1 N.Y.2d 570, 154 N.Y.S.2d 898, 136 N.E.2d 862 (1956). The Burkin decision has been reversed in New York by statute. See N.Y. Civ. Prac. Act § 1448.

[8] For a discussion of the potentialities of arbitration for settling disputes in close corporations and of the planning and drafting precautions that make arbitration provisions more effective and less vulnerable to attack, see O'Neal, Close Corporations: Law and Practice §§ 9.08-9.25 (1958).

were to become the seller, would not reflect an added element of value for power to control the corporation. Actually, however, in a small business corporation, where the participants usually consider themselves "partners" and conduct the internal affairs of the business very much as though they were partners, there is very little reason, in a buy-out arrangement among the participants, to provide for payment of a higher price per share to the majority shareholder than to the minority shareholder. In the business bargain which persons organizing a corporation reach before it is brought into existence, they usually agree (if not expressly, then by the way shares are to be allotted) on how each of them is to participate in dividends and in assets on dissolution; if participation in assets on dissolution is to be in proportion to shareholdings, the price received by a shareholder when he sells his interest might well depend simply on the number of shares he holds, without regard to whether his holdings are sufficiently large to give control of the corporation. Of course, a shareholder with a small interest might find it difficult to raise sufficient funds to buy out the larger interest of his associate, but provision could be made for the person who buys the other's interest to have the privilege of making a relatively small down payment and of paying the balance in specified installments and at designated interest rates.

§ 7.05. *Shareholders' agreements*

Undoubtedly the most frequently used device for giving protection to minority shareholders against squeeze-outs is a contract among the shareholders. Perhaps one reason for the frequency with which shareholders' agreements are used is the relative ease of preparing such agreements.

Among provisions which might be included in a shareholders' agreement to help forestall squeeze-outs are the following: (1) specified shareholders or their nominees are to constitute the board of directors; (2) each shareholder is to be employed in a key position by the corporation at a specified salary; (3) salaries of officers and key employees are not to be changed except by unanimous consent of the shareholders; (4) each shareholder or each of specified shareholders is to have the power to veto some or all corporate decisions;

(5) whenever the corporation's surplus exceeds a specified sum, dividends in the amount of the excess will be paid to the shareholders; (6) a shareholder will not transfer his shares until he has first offered them to the corporation and to the other shareholders; and (7) disputes among the participants are to be submitted to arbitration for settlement. The parties might also consider including in the agreement a statement that a breach of the covenants therein will result in irreparable damage, which damage is not measurable in money, and that therefore the parties agree to injunctive relief to compel compliance.[9]

A lawyer preparing a shareholders' agreement should study the applicable state law with great care to determine whether the provisions he wants to use are legal, and he should use caution in drafting the provisions.[10] Shareholders' agreements are challenged in court much more often than the average lawyer realizes. Nevertheless, provisions of the type listed in the preceding paragraph, to the extent that they will be given effect by the courts, set up a bulwark against some of the most common squeeze-out techniques.[11] For example, a shareholders' agreement which assures a particular shareholder that he will be employed by the corporation at a specified salary and that if salaries are raised his will be increased in proportion to those of other participants of course protects him against the other shareholders' "ganging up" on him and excluding him from company employment while they siphon off corporate earnings by high compensation to themselves. Similarly, a provision requiring payment of dividends assures a shareholder that he will get some return on his investment if the business is profitable and other participants can be prevented from draining off corporate earnings.

A study of the cases reveals that many variations are to be found in shareholders' agreements. For example, one agreement provided that the parties "entered into a contract for the purpose of permitting

[9] See Schmith v. Fornander, 200 N.Y.S.2d 505, 508 (Sup. Ct. 1960).

[10] For a detailed discussion of considerations affecting the validity of shareholders' agreements and of planning and drafting precautions that can be taken to strengthen such agreements, see O'Neal, Close Corporations: Law and Practice, ch. V (1958).

[11] A prominent Buffalo lawyer, in discussing his firm's use of shareholders' agreements which allocate, control, and fix salaries, comments as follows: ". . . I think that for the most part the agreements have served as a deterrent in many cases where a majority stockholder would have taken some action inimical to the interest of the minority stockholder but for the fact that the agreement did exist." Letter from Donald S. Day of Buffalo, N.Y., dated Sept. 24, 1959.

equality of control, for the sharing of the corporate offices and for the payment to them of stated salaries."[12] Another agreement provided that each of the two principal shareholders would vote for fixed salaries for the other, that the salaries would remain in the same proportion to each other for the duration of the agreement, and that the two would divide the corporation's profits in the same proportion when the surplus reached $10,000.[13] Still another agreement provided that ownership of 150 shares of corporate stock would carry with it the right to hold a corporate office.[14]

These cases, however, are only illustrative of the kinds of clauses that can be included in shareholders' agreements.[15] The resourceful draftsman will think of other provisions which will be useful in the particular business situation with which he is dealing.

§ 7.06. *Provisions requiring the declaration of dividends*

As has been pointed out in Chapter III,[16] the most frequently used squeeze-technique is the withholding of dividends. Naturally a prudent businessman who is acquiring a minority interest in an enterprise or the lawyer who is advising him is likely to think of the possibility of protection through an agreement among the participants or a charter or by-law provision which makes the declaration of dividends mandatory in certain circumstances, perhaps, whenever the corporation's surplus exceeds a specified figure.[17]

Courts have sustained shareholders' agreements (if all the shareholders are parties)[18] and charter and by-law provisions which provide

[12] Heller v. Clark Merchandisers, 154 N.Y.S.2d 150 (Sup. Ct. 1955) (proceeding in the nature of mandamus held not available for enforcement of this agreement as other remedies—suit for specific performance and damages for violations of contractual rights—were available).

[13] Carr. v. Kimball, 153 App. Div. 825, 139 N.Y. Supp. 253 (1912).

[14] Lockley v. Robie, 276 App. Div. 291, 94 N.Y.S.2d 335 (1950).

[15] For an elaborate and unusual shareholders' agreement, see Simonson v. Helburn, 198 Misc. 430, 97 N.Y.S.2d 406 (1950).

[16] See § 3.04.

[17] For an agreement among all the shareholders providing that one shareholder will be general manager and will receive a salary to be fixed by the board of directors, and requiring the corporation to distribute its net annual earnings to the other shareholders, see Thompson v. Thompson, 214 S.C. 61, 51 S.E.2d 169 (1948).

[18] In giving effect to a shareholders' agreement to divide corporate profits, the court in Merlino v. West Coast Macaroni Mfg. Co., 202 P.2d 748, 751 (Cal. App. 1949), commented: "There can be no question but that an agreement between stockholders who own substantially all of the stock of a corporation is enforceable against the contracting parties and the corporation."

for mandatory dividends,[19] in the few cases which have been decided. Thus, in a leading Masschusetts decision the Supreme Judicial Court upheld a by-law providing that the corporation's net surplus should not be accumulated to an amount exceeding $1,000,000 and that whenever the surplus exceeded that amount dividends should be declared and paid at the rate of $3,000 per share per annum.[20]

Thought must be given, however, to the fact that an agreement or charter or by-law provision which deprives the directors of their customary discretion to decide whether to declare dividends and, if so, the size of the dividends to be declared, might drain off the corporation's working capital or deprive it of power to accumulate earnings to meet needed expansions or anticipated contingencies. Perhaps this objection can be met by giving the directors power to withhold reasonable amounts for working capital and contingencies. A more serious objection to a provision for mandatory dividends is that it might be extremely costly taxwise: the directors might be required to declare and pay dividends at a most inappropriate and disadvantageous time from the tax viewpoint.

§ 7.07. *Long-term employment contracts between shareholder and corporation*

Not uncommonly persons organizing a small business corporation invest practically all their money and assets in the enterprise. They may expect to devote their full time to the business and to earn their livelihood largely by working for it. Therefore, minority shareholders need assurance that they will be retained in the company's employment.

A person who is taking a minority interest can to some extent protect himself against being deprived of employment with the

[19] Arizona Western Ins. Co. v. L. L. Constantin & Co., 247 F.2d 388 (3d Cir. 1957) (charter provision); Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 20 N.E.2d 482 (1939) (by-law); Morrison v. St. Anthony Hotel, 295 S.W.2d 246 (Tex. Civ. App. 1956) (shareholders' agreement, the terms of which were incorporated into the charter and were also stated on share certificates).

[20] Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 20 N.E.2d 482 (1939). This case and other disputes and attempted squeeze-outs which occurred among the owners of the company manufacturing the Lydia Pinkham medicine are discussed in a lively book by Jean Burton entitled Lydia Pinkham Is Her Name (New York, Farrar Straus & Co., 1949).

company by insisting on a long-term employment contract. Note that what is contemplated here is not an agreement among the shareholders but a contract between the corporation and a particular shareholder-employee.

To guard against the possibility that when the corporation grows and becomes prosperous the salaries of majority shareholders will be increased without a proportionate increase in his compensation, the minority shareholder may insist that his employment contract include, in addition to a basic salary, some provision for contingent compensation (e.g., a percentage of profits) or an arrangement under which his salary will be increased in a fixed proportion with salaries of designated corporate officers. Furthermore, he might insist upon the contract including provisions for severance pay or liquidated damages in the event the corporation breaches the contract, or provisions obligating the corporation to purchase his stock[21] or give him a lifetime pension in the event it discharges him or fails to renew his contract.[22]

The protection afforded a minority shareholder by a long-term employment contract, however, is tenuous and incomplete. In the first place, the validity of long-term employment contracts is still somewhat uncertain in some jurisdictions.[23] Furthermore, the courts generally will not specifically enforce an employment contract;[24] and of course damages usually will not be an adequate remedy to a minority shareholder who has invested everything he has in the company and is depending on employment by it for his livelihood. Finally, those in control of a company can make a shareholder-employee's life miserable by refusing to co-operate with him and by taking various steps to make his work unpleasant or unrewarding, such as effecting changes in his duties and in the locale to which he is assigned.

[21] "I have also used an employment contract coupled with a formula for the corporation's repurchase of the minority shares upon termination of this contract as a device for protecting an active minority shareholder." Letter from Donald F. Keefe, attorney of New Haven, Connecticut, dated Sept. 21, 1959.

[22] For a detailed discussion of problems involved in drafting long-term employment contracts and of precautions that should be taken, see O'Neal, Close Corporations: Law and Practice, ch. VI (1958).

[23] General Paint Corp. v. Kramer, 57 F.2d 698 (10th Cir.), cert. denied, 287 U.S. 605 (1932); Borland v. John F. Sass Printing Co., 95 Colo. 53, 32 P.2d 827 (1934); Carney v. New York Life Ins. Co., 162 N.Y. 453, 57 N.E. 78 (1900); Annots., 135 A.L.R. 646 (1941), 35 A.L.R. 1432 (1925).

[24] Williston, Contracts § 1423A (rev. ed. 1937).

§ 7.08. *Charter or by-law provision requiring high vote for shareholder and director action*

Perhaps the most effective way of protecting a minority shareholder against a squeeze-out is to include in the charter or by-laws a provision requiring unanimity or a high vote for shareholder and director action. Such a provision gives a minority shareholder a veto over corporate decisions.

Obviously, if a favorable vote of holders of 85 per cent of the shares outstanding is required for shareholder action, a person who holds 20 per cent of the shares is in a position to prevent shareholder approval of any resolution he finds objectionable. The shareholders elect the directors, at least in the absence of a shareholders' agreement designating the directors; and, under modern corporation statutes, shareholder approval is required for fundamental corporate acts such as charter amendment, sale of all assets, merger, consolidation, or dissolution. Thus a high vote requirement for shareholder action gives a minority shareholder a veto over the personnel of the directorate and protects him against the various squeeze-out techniques (discussed in Chapter IV) which involve fundamental corporate acts.

A high vote requirement for shareholder action alone however, does not give a veto over many management or policy actions which might be used in a squeeze-play. To protect a minority shareholder against certain types of squeeze-plays, he needs to be given a veto over action within the province of the board of directors, including the hiring and discharge of employees, changes in employees' compensation, execution of contracts, lending of money, issuance of additional corporate stock, and decisions to purchase or not to purchase shares of the company's stock under first-option arrangements. To give a minority shareholder a veto over acts of this kind, it is necessary to set up a high vote requirement for director action and to couple that high vote requirement with an arrangement which assures the minority shareholder representation on the board of directors.

A shareholder can be assured of representation on the board of directors in a number of ways. Not uncommonly when a small corpo-

ration is organized each shareholder is given membership on the initial board. If a shareholder is on the first board of directors and a high vote is required for shareholder action, he can prevent the election of a new board; in most states the old board carries over until a new board is elected and qualifies. Another way of giving a minority shareholder representation on the board is by a unanimous shareholders' agreement which designates him or his nominee as a director. A third way is to classify the shares, giving the minority shareholder all the shares of one class and providing that each class of shares will elect a designated number of directors. It is quite common now in small corporations for stock to be classified into Class A, Class B and Class C stock, with the only difference between the classes being that each class votes for a different director or group of directors.

The way in which high vote requirements can be used to prevent the elimination or circumvention of cumulative voting illustrates how effective such requirements are in protecting the rights of minority shareholders. The various attacks that can be made on cumulative voting have been set forth and discussed in another section.[25] Those attacks can be met, however, by a charter provision which requires unanimity or a high vote for charter amendments, a decrease in the number of directors, or the issuance of additional stock.

In many states high vote requirements can be provided for either in the charter, in the by-laws, or in a shareholders' agreement. Usually inclusion in the charter is the safest and most effective course to follow, but careful attention must be given to local state laws in deciding whether to use high vote requirements, how to phrase them, and what instruments to use in setting them up.[26]

§ 7.09. *Cautions in using high vote requirements*

Even though high vote requirements are perhaps the most effective safeguards against squeeze-outs, the protection they give minority shareholders must be weighed against risks and disadvantages they bring for the company and majority shareholders.

[25] See § 5.08.
[26] See O'Neal, Close Corporations: Law and Practice, ch. IV (1958).

Here are some points to keep in mind. First, a shareholder with a veto may use his veto power to extort unfair concessions from his associates as a condition to giving his approval to desired corporate action.[27] Second, veto arrangements deprive a corporation of flexibility which it may need to adjust to new situations. Third, high vote requirements greatly increase the chance of deadlock and corporate paralysis and raise the difficult question of what arrangements can be set up to break deadlocks when they develop.[28]

To minimize the disadvantages in the use of veto arrangements, the scope of the veto can be limited to areas in which it is felt protection is most needed by the minority shareholders—perhaps to fundamental corporate action and to decisions on the employment and discharge of key employees and the fixing of their compensation. The risk of deadlock of course grows as the number of shareholders increases. If a corporation is to have more than four or five shareholders, it may be unwise to give a single shareholder power to veto corporate action. In a corporation with seven shareholders and a seven-man board, for instance, it may be preferable to set the vote for shareholder and director action in a way which requires concurrence of two shareholders or directors to effect a veto.

§ 7.10. *Providing a veto by tailoring the corporation's share structure*

In a two-man company or one with two factions of shareholders, the share structure can be tailored to provide a veto to each shareholder even though high vote requirements are not used. If a company has only one class of shares and the shares are held by the two

[27] That a shareholder's attitude toward high vote requirements is likely to depend on the percentage of the shares he holds is illustrated by the following extract from a letter from a California lawyer who has had a great deal of experience with such requirements: "With respect to the usage of charter and bylaw provisions requiring high votes for shareholders' and directors' actions, I have been involved in the drafting thereof in all three situations, that is, where our client holds a minority interest and individuals hold the majority, where our client is a 50-50 'partner' with another individual or company, and where our client holds a majority and one or more individuals hold the balance of the stock. Pragmatically, I have drafted upon the basis that our client should have a veto when he holds the minority, as much leverage as possible when the deal is 50-50, and as much latitude as possible when he is the majority stockholder." Letter from David Hardy, Oakland, California, dated Sept. 28, 1959.

[28] For a discussion of arrangements for resolving deadlocks in close corporations, see O'Neal, Close Corporations: Law and Practice, ch. IX (1958).

shareholders on a fifty-fifty basis, a new board of directors obviously cannot be elected nor other shareholder action taken unless both shareholders concur.

Where contributions to the corporation are unequal or for other reasons one shareholder is to have a greater proprietary interest (i.e., a greater interest in dividends and in assets on dissolution) than the other, two classes of shares, one with voting power and one nonvoting, can be used, with the voting stock divided equally between the two participants and the nonvoting stock distributed in a way to achieve the desired division of proprietary rights.

Another approach is to classify both the shares and the directorate; two classes of stock could be used, with the classes having identical rights except that Class A stock would elect the two Class A directors of the four-man board and the Class B stock would elect the two Class B directors. The two classes of stock need not have the same number of shares.

§ 7.11. *Providing a veto over officer action*

As the principal corporate offices will usually be held by majority shareholders or by persons responsive to their wishes, a minority shareholder will want to be in a position to prevent any action by those officers which would be prejudicial to his interests. To decrease the chance of unfavorable officer action, the by-laws might define the duties and powers of the officers in narrow terms and prohibit the delegation of any important work of the board of directors to officers or committees.

Another approach that can be taken is to require the concurrence of two or more officers for certain important action. It is fairly common, for instance, to require the signature of two officers, say the president and treasurer, on corporate checks and other negotiable paper. Under such an arrangement, if the minority shareholder holds the office of treasurer, he is of course in a position, by withholding his signature, to prevent the borrowing of money or the expenditure of corporate funds.[29]

[29] See Berdane Furs, Inc. v. First Pennsylvania Banking and Trust Co., 190 Pa. Super. 639, 155 A.2d 465 (1959), where the corporation opened a commercial checking account and filed with the bank a certified copy of a resolution of its board which provided: ". . . that until otherwise ordered, said Bank be and hereby is authorized to make payments from said account upon and according to the check, draft, note

§ 7.12. *Special charter and by-law provisions*

Special charter or by-law provisions, other than high vote requirements for shareholder and director action, can often be used to diminish the risk of squeeze-outs. For instance, a clause can be inserted in the charter to broaden and strengthen shareholders' pre-emptive rights. A provision of that kind provides some protection to minority shareholders against dilution of their voting power or their proportionate interest in the corporation by the issuance of additional shares to majority shareholders. To give a minority shareholder any real protection, pre-emptive rights must be made applicable to stock issued for property and to stock issued in payment of a debt and to the reissuance of stock purchased by the corporation and held as treasury shares.

The hand of a minority shareholder who is fighting against a squeeze-play is considerably strengthened by a charter or by-law provision which gives a shareholder an unqualified right to examine personally or by representative all corporate books, contracts, accounts, correspondence, memoranda, and other records and to copy those documents and records. A provision of this kind avoids whatever questions and delays might otherwise arise out of uncertainty as to the scope of a shareholder's common law or statutory inspection rights; however, if an inspecting shareholder behaves unreasonably or if he seeks information for improper purposes, such a provision can be a real thorn in the side of even the most honest and conscientious management. Consideration might also be given to a clause which would require the president or some specified corporate officer to report periodically to the shareholders on company affairs or to render on request full information on any designated corporate matter to a shareholder, the legal representative of a deceased shareholder, or the representative of a shareholder under legal disability.[30]

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or order of this . . . Corporation . . . when signed by President and Treasurer . . . without inquiry as to the circumstances of their issue or the disposition of their proceeds. . . ." The court in the Berdane Furs case, however, held that the corporation by a course of dealing (repeatedly issuing negotiable paper over the signature of just one of the authorized officers) had estopped itself from setting up against the bank noncompliance with the resolution.

[30] See Winer, Proposing a New York "Close Corporation Law," 28 Cornell L. Q. 313, 341 (1943).

To guard against the siphoning off of corporate profits in the form of exorbitant compensation to majority shareholder-employees, a person entering a small business as a minority shareholder might well insist on a charter or by-law provision which fixes a maximum limit on compensation of corporate officers. As has been pointed out,[31] the vague equitable limitations on the compensation of corporate officers does not really furnish an effective safeguard against excessive executive compensation. A fixed limit on compensation might avoid expensive and risky litigation.

Another provision which might be considered is one which would require an outside firm to examine the company's assets and business periodically and place a value on its shares.[32] If this were done, an objective evaluation of the company's shares would be available on which to base negotiations for a buy-out, whenever a dispute developed or a participant decided to leave the business. Consequently, long drawn-out negotiations in which each party comes to believe that the other is behaving arbitrarily and unreasonably—the type of frustrating situation that breeds attempts at squeeze-out—can be avoided. A disadvantage of this kind of provision is of course the cost of the periodic appraisals.

There are a considerable number of organizations whose principal function is expert appraisal of business enterprises. Perhaps some disputes as to values can be avoided simply by making known to small businessmen the ready availability of such services.

Whenever provisions are inserted in the charter or by-laws with a view to protecting minority shareholders (including high vote requirements for shareholder and director action), precautions must be taken to prevent an amendment of the charter or by-laws to eliminate the protective clauses. In other words, clauses designed to safeguard the rights of minority shareholders must be "backstopped" by high vote requirements for charter and by-law amendment or by some other device to prevent majority shareholders from first removing the protective clauses from the charter or by-laws and then effectuating the squeeze-out.

[31] See § 3.06, *supra*.

[32] In Standard Int'l Corp. v. McDonald Printing Co., 159 N.E.2d 822, 824 (Ohio C. P. 1959), one of the witnesses testified that when the question of valuation of the company's stock came up in regard to valuation if one of the shareholders should die, it was decided to have Moody's place a periodic valuation on the stock.

§ 7.13. *Guarding against squeeze-outs in partnerships*

This section considers in general terms the various arrangements partners can set up to avoid disputes and resolve those which do arise, prevent oppression of a partner and facilitate redress if it occurs, and give a dissatisfied partner a way out of the enterprise without serious financial loss to himself or his co-partners. The partnership form is organizationally very flexible, and arrangements to insure protection are as varied as the imagination of the partners and their business advisers.

As a partnership (in contrast to a corporation) can be formed orally or by implications arising from the conduct of the parties,[33] the most important single act that a prospective partner can take to protect himself is to make sure that the partnership agreement is in writing and that it includes all agreed-upon terms. Although prospective partners unquestionably should seek the assistance of attorneys in working out their business bargain and preparing articles of partnership, it is important that they reduce their agreement to writing even if they do not obtain legal advice. A written agreement, though prepared by the partners themselves, is greatly preferable to an oral agreement.

A substantial number of the partnership squeeze-out cases involve oral partnership agreements,[34] oral modifications of written partnership agreements,[35] and "agreements" which are nothing more than vague understandings never definitely stated, even orally.[36] Partners may honestly misunderstand, misinterpret, or forget oral terms; they may have "convenient memories." Additionally, unless all of the business bargain is put in writing, the written agreement

[33] 1 Barrett & Seago, Partners & Partnerships: Law & Taxation 294-96 (1956); Uniform Partnership Act (hereinafter referred to as U.P.A.) § 7. See also, Rizzo v. Rizzo, 3 Ill.2d 291, 120 N.E.2d 546 (1954); Holst v. Butler, 379 Pa. 124, 108 A.2d 740 (1954); Keen v. Jason, 187 N.Y.S.2d 825 (Sup. Ct. 1959).

[34] See, e.g., Aitchison v. Anderson, 183 F.2d 922 (9th Cir. 1950); Nelson v. Abraham, 29 Cal.2d 745, 177 P.2d 931 (1947); Graham v. Street, 109 Utah 180, 166 P.2d 524 (1946); Waagen v. Gerde, 36 Wash.2d 563, 219 P.2d 595 (1950); Kennedy v. Yost, 32 Del.Ch. 386, 88 A.2d 297 (1952); Boxill v. Boxill, 111 N.Y.S.2d 33 (Sup. Ct. 1952).

[35] See, e.g., Latta v. Kilbourn, 150 U.S. 524 (1893); Brownback v. Nelson, 122 Mont. 525, 206 P.2d 1017 (1949); Schroer v. Schroer, 248 S.W.2d 617 (Mo. 1952); Stark v. Reingold, 18 N.J. 251, 113 A.2d 679 (1955); Engstrom v. Larson, 77 N.D. 541, 44 N.W.2d 97 (1950), 79 N.D. 188, 55 N.W.2d 579 (1952).

[36] See, e.g., Degen v. Brooks, 77 N.D. 514, 43 N.W.2d 755 (1950); R. C. Gluck & Co. v. Tankel, 199 N.Y.S.2d 12 (Sup. Ct. 1960).

is signed by each of the partners, and copies are given to and preserved by each partner, the door is left open for unscrupulous partners to make up their own terms as they go along. Partners may claim that there is no partnership, or that various agreements were or were not made at the inception of the partnership. The cases show that partners frequently disagree on what arrangements (if any) they have made to cover distribution of profits, sharing of losses, managerial rights of the partners, and the many other terms of their business bargain.

Not only can partners be more certain of their rights, powers, and obligations when the partnership agreement is reduced to writing, but courts are more apt specifically to enforce written agreements. Furthermore, the process of preparing a written agreement causes the parties to think through their problems more carefully than they otherwise would. Partners should be cautioned that the closeness of the partners to each other because of familial or other relationships does not diminish their need to reduce their whole business bargain to writing.

As soon as two or more people decide that they want jointly to conduct a business in the form of a partnership, they should obtain attorneys, explain their plans to the attorneys, and discuss their ideas about the management and operation of the enterprise. The attorneys then might consult other skilled business advisers, such as accountants, before preparing the partnership agreement. Drafting this agreement is essentially the drafting of a simple contract.

> Within the broad limits of the few statutory and public policy restrictions on the contents of a partnership agreement, the partners may agree on anything they wish. The chief task of the draftsman is to ascertain what they do wish, to think out in advance the typical problems that are likely to arise, to discuss these with his clients, to work out decisions as to how they are to be treated, and to set the results down in clear language. Since a partnership is an extremely intimate relationship, perhaps the greatest potential problem is the risk of future disagreement among those who start out with the highest mutual regard.[37]

The agreement should cover the following: (1) financing and financial agreements, i.e., capital contributions, interest, profits and

[37] Worcester, Comment: The Drafting of Partnership Agreements, 63 Harv. L. Rev. 985, 985-86 (1950). For a check list of facts to be ascertained before drafting a partnership agreement, see Mulder & Volz, The Drafting of Partnership Agreements 4-10 (1955).

losses, salaries, and accounting; (2) management, control, and partner participation; and (3) withdrawal, dissolution, and termination.[38]

Within each of these areas, the attorneys must select provisions which will best protect the partners. The amount and form of each partner's capital contributions should be stated. If special assets, such as patents, tools, or other equipment are to be loaned or rented to the firm rather than contributed as part of the capital investment, this should be clearly indicated. If the partners are to receive interest on their capital contributions, this should be stated in the agreement, with a clear indication of the amount of interest and of the time when it is payable.

In the absence of specific provisions in the agreement, a partner is not entitled to a salary but only to a distribution of profits.[39] The agreement should state the method and time of distribution and the method of determining profits. Provision for the division of losses should also be included, and the method of accounting should be defined and accounting periods set for determining profit and loss.

If the partners are to receive salaries, specific provision must be made. The agreement should indicate whether salaries, along with interest on capital, if any, will be considered business expense to be deducted before determining net profits. The proportionate relationship of each partner's salary to that of the others should be stated in order to prevent later unequal modification; provision should also be made for future salary changes, the method by which this is to be accomplished, and the number of partners whose consent is necessary (1) to change all salaries and (2) to alter the original relative proportions. The partners should also place an appropriate statement in the agreement indicating whether they are to have a right to make advance withdrawals against salary or profits or to withdraw capital contributions.

Unless they have agreed otherwise, all partners have equal rights in the management and control of the business.[40] Decisions are made by a majority of the partners except that acts inconsistent with

[38] See Mulder & Volz, *op. cit. supra* Note 37 at 12-24; 1 Rabkin & Johnson, Current Legal Forms with Tax Analysis 17 (1957); Lattin, Corporations 22-24 (1959).

[39] See U.P.A. § 18 (a); Crane, Partnership 349 (2d ed. 1952). Cf. Levy v. Leavitt, 257 N.Y. 461, 467, 178 N.E. 758, 760 (1931).

[40] See U.P.A. § 18 (e).

the partnership agreement can be done only with the consent of all the partners.[41] The agreement should clearly define the managerial powers of the various partners. Specific provisions are particularly important if one partner is to have exclusive management powers or if the partners are otherwise to have unequal voices in partnership decisions. One point that must not be overlooked if management rights are taken away from a partner is that he may still have the *power* (as distinguished from the right) to bind the firm in transactions with outsiders.[42] Penalty provisions should be included to protect the partners from unauthorized exercise of these powers.

When majority rule prevails, the term "majority" should be defined to indicate whether it means a majority of the individual partners or a majority in interest in the partnership. The areas of decision may be classified and some matters delegated to a few of the partners with other matters to be decided by a majority or a higher percentage of the partners.

Dissension frequently develops when one participant becomes inactive but continues to draw a salary or to share in the firm profits. Not uncommonly this is one of the underlying causes of squeeze-outs.[43] One way to meet this problem is to provide in the partnership agreement for reduction of a partner's salary or percentage of profits after he has been absent from the business for more than a specified period of time. Provision could even be made for ouster of a partner from the firm for excessive absences. In one partnership, an absent partner had to pay a set sum to the partnership for each day of absence beyond a stipulated period.[44] In another firm, a concern engaged in the manufacture and sales of beverages, one of the partners married a wealthy woman and thereafter spent far less time than formerly on partnership affairs. His co-partners began to feel unhappy because they felt that they were bearing more than their share of the burden of operations. In order to reduce the possibility of strife and dissension, the firm's lawyer caused the partners to rearrange their business operations as follows: each partner was given a separate sales territory which he worked as an individual entrepreneur; the manufacturing plant was operated as a

[41] See U.P.A. § 18(h).
[42] See U.P.A. § 9. See also U.P.A. § 35.
[43] See § 2.03 *supra*.
[44] See Balian v. Rainey, 251 P.2d 731 (Cal. App. 1952).

partnership, but costs of operation and maintenance were allocated to each partner on the basis of his sales.[45]

To prevent partners from engaging in other activities to the neglect of partnership affairs, the partnership agreement can require each partner to devote his full time to the conduct of partnership business. It may also be advisable to include a provision defining the duties and participation of each partner. This will set lines of responsibility, indicate the work each partner is to do, and prevent a partner from encroaching on the jobs of others.

Various additional steps may be taken to implement statutory prohibitions against competition with the partnership and appropriation of partnership opportunities. Specific provisions should spell out the extent to which a partner may engage in activities similar to those encompassed by the business of the partnership. Partners' obligations and responsibilities to the firm when acting on information obtained through the business should also be stated. When such provisions are included, several advantages result. Partners' fiduciary duties are strengthened and remedies can be more easily secured in the event that fiduciary duties are violated.[46] If the provisions are properly drafted, the frequent necessity for judicial definition of a partnership opportunity in particular cases may be eliminated.[47] Protection will be afforded partners who honestly believe that their activities are proper since they may act within guidelines established in the agreement.

To give even greater protection, a partner who intends to engage in activity which may be construed as usurping a partnership opportunity can be required first to secure permission from his copartners. The penalty can be made greater whenever a partner should know that he may be acting within the ambit of partnership activity but fails to obtain permission. On the other hand, once written permission has been granted, the other partners cannot then decide that their co-partner appropriated a partnership opportunity and demand a share in the fruits of his particularly astute investments.

Arrangements should also be made to deal with disputes between partners. Arbitration provisions constitute one method of accomplish-

[45] Mentioned in letter dated Sept. 10, 1959 (Name of writer withheld to safeguard anonymity of parties.)

[46] See, e.g., Bakalis v. Bressler, 1 Ill.2d 72, 115 N.E.2d 323 (1953); Stark v. Reingold, 18 N.J. 251, 113 A.2d 679 (1955).

[47] See § 6.06 *supra.*

ing this.[48] Here, the method of selecting arbitrators must be chosen with care. Partners must realize that they cannot predict in advance how they will line up when a dispute occurs; therefore, they should not provide for the selection of arbitrators by prearranged groups of partners.[49]

Another way to solve disputes is to vest in one or several partners the power of final decision.[50] This, however, may lead to later difficulties in restraining the activities of the partners who are given this special overriding power.

The partners' rights of access to partnership books and records can also be covered by the partnership agreement. Although the Uniform Partnership Act specifically covers partners' informational duties,[51] the partnership agreement might not only incorporate these but go further and establish additional means of getting information to the partners. For instance, it can provide that independent certified public accountants will periodically audit the books and supply a certified report and financial statements to each partner and that the scope of the accountants' examination may not be limited. The agreement can also require that each partner be given a copy of the partnership's federal and state income tax returns.

Probably no one partner should be given sole control of the firm's financial affairs. Division of responsibility provides a built-in system of checks to prevent schemes for the appropriation of partnership assets from being initiated or at most from proceeding far before being discovered.

Not uncommonly partners decide to incorporate their enterprise or to form a number of corporations as the means through which they will conduct some or all of the partnership business.[52] The decision to incorporate may be made for various business reasons,[53]

[48] See, e.g., the use of arbitration agreements in the following cases: Borbach v. Borbach, 398 Pa. 561, 158 A.2d 546 (1960); Lowengrub v. Meislin, 376 Pa. 463, 103 A.2d 405 (1954); Friedland v. Friedland, 1 App.Div.2d 129, 148 N.Y.S.2d 328 (1956); Greenspan v. Greenspan, 129 N.Y.S.2d 258 (Sup. Ct. 1954).

[49] Compare Lipshutz v. Gutwirth, 304 N.Y. 58, 106 N.E.2d 8 (1952).

[50] Cf. 1 Barrett & Seago, Partners & Partnerships: Law & Taxation 482-84 (1956).

[51] U.P.A. §§ 19, 20.

[52] See, e.g., Lieberbaum v. Levine, 54 So.2d 159 (Fla. 1951); Van Hooser v. Keenon, 271 S.W.2d 270 (Ky. 1954); Stark v. Reingold, 18 N.J. 251, 113 A.2d 679 (1955); Fortugno v. Hudson Manure Co., 51 N.J. Super. 482, 144 A.2d 207 (1958); Loverdos v. Vomvouras, 200 N.Y.S.2d 921 (Sup. Ct. 1960); Hennessy v. During, 124 N.Y.S.2d 266 (Sup. Ct. 1953).

[53] See Broden & Scanlan, The Legal Status of Joint Venture Corporations, 11 Vand. L. Rev. 673 (1958).

or incorporation may be engineered by some of the partners to set the stage for squeezing out their co-partners.[54]

There is a split of authority on whether incorporation forecloses any further rights to partnership treatment and partnership remedies.[55] Since adoption of the corporate form or use of corporations to conduct partnership business can eliminate the protective characteristics present in the original partnership or joint venture, adequate and competent legal advice must be obtained before the partners decide to incorporate. If they do decide to incorporate or to form several corporations to transact the partnership's business, the attorney should utilize various corporate protective devices[56] to protect them against the corporate squeeze techniques they may encounter after the form of their business is changed.

It is particularly important that the partnership agreement cover withdrawal, dissolution, and termination. Ordinarily, any partner may dissolve the partnership,[57] and as long as he does not breach the partnership agreement he can force liquidation of the firm.[58] The partners can protect themselves against the consequences of involuntary liquidation by including provisions in the agreement which give partners remaining with the firm the right to continue the business in the event of withdrawal, expulsion, bankruptcy, or death of a partner. The remaining partners might be empowered to purchase a withdrawing partner's interest at a price established by prior agreement, and if so, they should be specifically granted permission to continue to use the firm name. Former partners should be prohibited from establishing a competing business or using the partnership name.

A partner should also be required to give advance notice of his intention to withdraw. The remaining partners will then have time to adjust to the change in personnel and to raise funds necessary to purchase the outgoing partner's interest. They will also have time to replace the withdrawing partner by either admitting a new member into the firm or by hiring an additional employee.

[54] See § 6.09 *supra*.

[55] See Ballantine, Corporations 423-24 (rev. ed. 1946); Rohrlich, Organizing Corporate and Other Business Enterprises 108 (3d ed. 1958); Broden & Scanlan, The Legal Status of Joint Venture Corporations, 11 Vand. L. Rev. 673 (1958); Note, Joint Venture Agreement Survives Incorporation, 16 Md. L. Rev. 348 (1956); Note, Incorporation Terminates Obligations between Joint Venturers, 55 Colum. L. Rev. 419 (1955).

[56] See §§ 7.01-7.12, *supra*.

[57] U.P.A. § 29, 31 (2).

[58] U.P.A. §§ 37, 38 (1). See also U.P.A. § 32 (Dissolution by decree of court).

Sometimes an affluent partner attempts to dissolve the firm or to obtain appointment of a receiver and liquidation of the business in order that he may purchase the business at a near-distress price. To prevent this, it may be advisable to provide in the partnership agreement that whenever a partner dissolves the firm or applies for the appointment of a receiver to wind up the business, the other partners will have the right to purchase his interest in the partnership at a price to be determined by a prearranged formula.

To avoid the strife which may arise when one partner does not properly perform his work and to prevent an unreasonable partner from disrupting business operations, the agreement may permit a stipulated number or percentage of partners to expel a partner for stated causes.[59] The provisions dealing with involuntary expulsion must be carefully drawn in order to protect both the outgoing partner and the other firm members. A high vote should be necessary to exercise this power, and a fair means should be provided for valuing and paying for the interest of an expelled partner. If the valuation method chosen is the same as that used for determining the value of the interest of a partner who withdraws voluntarily, a partner who wants to withdraw will not be encouraged to become obstructive with a view to forcing the other partners to expel him. Arrangements should also be made to provide for the purchase of the interest of a deceased partner.[60]

The partnership agreement should state how a retiring partner is to be paid for his interest. As the remaining partners may experience difficulty in raising the necessary funds to purchase an interest, advance arrangements should be made for them to pay part of the money immediately and the balance in installments over a period of time.

[59] See, e.g., Lyon v. Sanger, 107 N.Y.S.2d 300 (Sup. Ct. 1951); Gill v. Mallory, 274 App. Div. 84, 80 N.Y.S.2d 155 (1948).

[60] For discussion of problems involved in fixing a transfer price for a partnership interest subject to a buy-out arrangement, see Barrett & Seago, Partners & Partnerships: Law & Taxation 310-17 (1956); Mulder & Volz, The Drafting of Partnership Agreements 98-107 (1955); Polasky, Planning for the Disposition of a Substantial Interest in a Closely Held Business: Partnership, 45 Iowa L. Rev. 46 (1959).

CHAPTER VIII. IDEA GUIDES FOR CHANGES IN LEGAL CONTROLS

§ 8.01. *Scope of chapter*

This chapter discusses legislative measures and other possible changes in the law which might reduce the number of squeeze-plays and give holders of minority interests greater protection against oppression. It also sets forth legislative proposals which might make planning against squeeze-outs easier or more effective.

Attention is first directed to the need for increased discrimination in applying certain judicially created doctrines (such as the business judgment rule) which hinder the courts in granting relief to oppressed shareholders. Then consideration is given to the following legislative proposals: a statute which would compel corporate management to declare dividends; a statute modifying the standards determining the validity of charter amendments, mergers, and other fundamental corporate acts; and a statutory extension of appraisal

rights to protect objecting shareholders in any corporate transaction which adversely affects their rights in a substantial way.

A considerable amount of space is devoted to approaches the British have taken to the protection of minority shareholders. These include: (1) administrative supervision of English companies by a Board of Trade; (2) an amendment to the Companies Act to encourage the courts to be somewhat more liberal in ordering the winding up of companies in oppression cases; and (3) Section 210 of the Companies Act of 1948, a special provision designed to afford greater protection to minority shareholders and to broaden the remedies available to them. A section is also devoted to suggestions of an Irish committee on company law reform for certain modifications of Section 210.

The topic next discussed is the desirability of broadening the remedies available to minority shareholders in squeeze-out cases. Attention is called to some of the interesting decisions in which American courts have issued unique decrees to solve squeeze-play problems, and reference is again made to English law, this time to indicate the broad power that can be given to the courts to tailor decrees to meet the almost infinite variety of situations they encounter in squeeze-out cases. There is then discussion of the need (irrespective of what legislative or judicial safeguards against squeeze-outs may evolve) of giving shareholders in each business enterprise considerable freedom to set up among themselves contractual arrangements tailored to their own particular business situation. Finally, a few suggestions are made for changes in the law of partnership that might help decrease the number of partnership squeeze-plays.

§ 8.02. *Need for judicial discrimination in applying principle of majority control and the business judgment rule*

American courts traditionally have been reluctant to interfere in the internal affairs of corporations when dissension develops among shareholders or even when minority shareholders claim that they have suffered injustices.[1] The two principal conceptualistic

[1] Much of this section and of §§ 8.06-.08 is based on material originally printed in O'Neal, Oppugnancy and Oppression in Close Corporations: Remedies in America

barriers to the courts' granting relief to aggrieved shareholders in squeeze-plays are (1) the principle of majority rule in corporate management and (2) the business judgment rule. Those principles have been discussed in other sections of this study,[2] and that discussion will not now be repeated. The point emphasized here is the limited validity of those principles in small business corporations.

Apparently without close examination, courts accord the principle of majority rule the same sanctity in corporate enterprises, including small businesses, that it enjoys in the political world. The principle of majority rule is in traditional legal thought a firmly established attribute of the corporate form. Yet many participants in closely held corporations are "little people," unsophisticated in business and financial matters. Not uncommonly a participant in a closely held enterprise invests all his assets in the business with an expectation, often reasonable under the circumstances even in the absence of express contract, that he will be a key employee in the company and will have a voice in business decisions. Thus, when courts apply the principle of majority rule in close corporations, they often disappoint the reasonable expectations of the participants.[3]

The indiscriminate application of the business judgment rule to sustain action of directors in close corporations is also subject to criticism. That rule seems to be grounded on the following ideas: (1) shareholders have selected the directors to manage the business, and the courts are not justified in substituting their judgment for that of managers selected by the owners of the business; (2) directors' decisions are based on complex business considerations and courts are simply not qualified to make those decisions or to pass on their propriety in the absence of a clear abuse of discretion; and (3) a heavy burden should be placed on complaining shareholders to discourage "strike suits" and frivolous litigation.

These justifications for the business judgment rule, however, do not apply in all their vigor to a close corporation; courts may well consider intervention to protect minority shareholders in a

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and in Britain, 1 Boston College Ind. and Comm. L. Rev. 1 (1959). This material has been modified and is reprinted here with permission of the copyright holders.

[2] See §§ 1.03, 3.03, *supra*.

[3] See Standard International Corp. v. McDonald Printing Co. Inc., 159 N.E.2d 822 (Ohio C.P. 1959), for a decision which protected the expectations of the original shareholders in a small business corporation and perpetuated the company on the basis on which it had originally been set up, even though the court had to ignore established principles of corporation law to do so.

close corporation against oppressive action by the directors (unfair dividend policies, for example), even though fraud, bad faith or, for that matter, clear unreasonableness on the part of the directors cannot be shown. Participants in a close corporation do not usually think of themselves as delegating management of their corporation to an independent board of directors; a board is often viewed only as a legal formality. Owners and managers, insofar as the participants look into the future, are to be the same. Minority shareholders expect to share in management.

It hardly seems necessary in all cases to say, as the courts so often have said in effect, that when a person becomes a shareholder in a corporation, he assumes a status with all of its legally built-in liabilities, irrespective of his and his associates' intentions and expectations. Further, in a close corporation, where the business considerations on which directors' decisions are based are likely to be somewhat less intricate than in public-issue corporations and the directors making the decisions are likely to be somewhat less astute, there is less reason for judges to show an unquestioning deference to decisions of a directorate. Finally, the great practical danger of a too-ready judicial interference with public-issue corporations, the danger of encouraging "strike suits," is not present, at least not in the same degree.

Perhaps the courts' concern about usurping functions of the board of directors is misplaced for an additional reason in cases passing on the reasonableness of executives' compensation. Small business corporations seldom have independent and disinterested directors making the decisions on the size of salaries or the amounts of other compensation; the directors are almost always both shareholders and officers or they are closely controlled by majority shareholders.

In spite of the principles of majority rule and the business judgment rule, the courts in this country are moving steadily, though slowly and often clumsily and gropingly, to provide a remedy for oppressed minority shareholders. This they are doing principally by imposing a fiduciary duty on controlling shareholders and corporate directors for the benefit of minority interests, and by gradually expanding the scope of that fiduciary duty.[4]

In imposing this duty the courts perhaps are simply applying

[4] See § 5.15, *supra*.

the ethical standards of the business community. It is interesting to note that the British also fall back on fundamental notions of fairness and justice in deciding when to come to the aid of minority shareholders. Thus Lord President Cooper, in *Elder* v. *Elder & Watson,* Ltd.,[5] in considering what classes of cases Section 210 of the English Companies Act[6] was intended to cover, commented that "the essence of the matter seems to be that the conduct complained of should at the lowest involve a visible departure from the standards of fair dealing, and a violation of the conditions of fair play on which every shareholder who entrusts his money to a company is entitled to rely."

The ethical standards of the American business community have progressed far since the "robber baron" days when it was considered good business practice to squeeze out a competitor or an associate, and they give every indication of further advances; American courts, therefore, are quite likely to broaden the classes of cases in which they will interfere to aid oppressed shareholders. In an age when small businessmen hear "brotherly love" speeches in their civic clubs at least once a year, most of the squeeze-plays heretofore used to eliminate business associates can hardly be considered "cricket." Perhaps in the not too distant future American courts will uniformly insist that majority shareholders refrain from any conduct which can reasonably lead to the inference that the interests of other shareholders or the interests of the company as a whole are being ignored. Eventually the courts may even impose some duties on minority shareholders, e.g., that they refrain from spiteful conduct that harms the business and that they avoid acting in ways that make it impossible for the majority to co-operate with them.[7]

§ 8.03. *Statute compelling declaration of dividends*

An obvious way to combat squeeze-outs which utilize the dividend-withholding technique is to enact a statute which requires the

[5] [1952] Sess. Cas. 49, 55 (Scot).

[6] Discussed in § 8.07, *infra.*

[7] "The minority, however, may also act for personal reasons without considering the best interests of the corporation and disturb the success of the corporation in order to favor, for example, a competitor's operation, so that rules of equilibrium exist to strike a balance in keeping each group in line." Torem and Focsaneanu, Minority Stockholders' Rights under French Law, 15 The Bus. Law. 331 (1960). See also, English Companies Act, 1948, § 209, which in some circumstances empowers majority shareholders to force holders of 10 per cent or less of the shares to sell their interest.

directors to declare and pay dividends from surplus or profits at periodic intervals. Objections which may be raised to such a statute (these have already been mentioned in the discussion of charter and by-law clauses or contractual provisions compelling the declaration of dividends[8]) are: (1) it might have tax disadvantages since substantial dividends might have to be declared at a time when shareholders are in high income tax brackets, and (2) it might handicap corporate operations by preventing the directors from accumulating funds to carry the corporation through lean years or to provide for expansion. Actually, however, a statute of this kind, if it were adopted in all states so that the tax effect would be uniform throughout the country, might from a tax policy viewpoint even be desirable; it would prevent the timing of distributions to cut taxes and would probably decrease maneuvering to get earnings out of the corporation and into the hands of the shareholders at capital gain rates.

A few states have statutes which require the declaration of dividends. New Jersey and a number of other states[9] at one time had statutes similar to the present New Mexico statute, which reads as follows:

> Unless otherwise provided in the original or amended certificate of incorporation, or in a by-law or resolution adopted by a vote of at least a majority of the stockholders, the directors of every corporation created under this article shall, in January in each year, after reserving over and above its capital stock paid in, as a working capital for said corporation, such sum, if any, as shall have been fixed by the stockholders, declare a dividend among its stockholders of the whole of its accumulated profits exceeding the amount so reserved, and pay the same to such stockholders on demand.[10]

This statute has a number of defects. In the first place, it does not provide any real protection to minority shareholders against a dividend-withholding squeeze-play; majority shareholders by charter or by-law amendment or simply by resolution passed at a shareholders' meeting can eliminate the dividend requirement. Furthermore, the terms "working capital" and "accumulated profits" are undefined and encourage litigation.[11]

[8] See § 7.06, *supra.*

[9] See Amick v. Coble, 222 N.C. 484, 23 S.E.2d 854 (1943), for discussion and application of a statute which was once in effect in North Carolina.

[10] N.M. Stat. Ann. § 51-3-16 (1953).

[11] See Amick v. Coble, 222 N.C. 484, 23 S.E.2d 854 (1943) (under old North Carolina statute, income tax, allowance for bad debts, and inventory adjustment were deductible in ascertaining "net profits"; directors had to act in good faith in fixing working capital).

Much better legislation is the unique provision in the present North Carolina statute, which provides in part as follows:

If during its immediately preceding fiscal period a corporation has paid to any class of shares dividends in cash or property amounting to less than one-third of the net profits[12] of said period allocable to that class, the holder or holders of twenty per cent (20%) or more of the shares of that class may, within four months after the close of said period, make written demand upon the corporation for the payment of additional dividends for that period. After a corporation has received such a demand, the directors shall, during the then current fiscal period or within three months after the close thereof, cause dividends cash or property to be paid to the shareholders of that class in an amount equal to the difference between the dividends paid in said preceding fiscal period to shareholders of that class and one-third of the net profits of said period allocable to that class, or in such lesser amount as may be demanded. A corporation shall not, however, be required to pay dividends pursuant to such demand insofar as such payment would exceed fifty per cent (50%) of the net profits of the current fiscal period in which such demand is made or insofar as the net profits are being retained to eliminate a deficit. Upon receipt of such a demand a corporation may elect to treat any dividend previously paid in the current fiscal period as having been paid in the preceding fiscal period, in which even the corporation shall so notify all shareholders. If a dividend is paid in satisfaction of a demand made in accordance with this subsection it shall be deemed to have been paid in the period for which it was demanded, and all shareholders shall be so informed concurrently with such payment.[13]

The North Carolina statute, it is to be noted, in that it requires payment only of one-third of the net profits during a fiscal period and sets up other safeguards, is not likely to deprive a corporation of funds it needs in its operations. Moreover, since holders of 20 per cent of the shares of a class must join to demand dividends, the holder of a few shares cannot extort concessions from his associates by threatening to compel dividends at a time inopportune from a business or tax point of view. On the other hand, the statute wisely

[12] N. C. Gen. Stat. § 55-50 (i) (Supp. 1959) also provides that the term "net profits" as used in that subsection means "such net profits as can lawfully be paid in dividends to a particular class of shares after making allowance for the prior claims of shares, if any, entitled to preference in the payment of dividends, but in the determination of such profits the provisions of subsection (d) of this section [which permits a corporation engaged in exploiting natural resources to compute its earned surplus or net profits without deduction for the depletion of such resources] shall not apply."

[13] N.C. Gen. Stat. § 55-50 (i) (Supp. 1959).

leaves intact the shareholder's rights to compel dividends under general principles of equity.[14]

§ 8.04. *Statutory modification of standards to be applied in determining whether to set aside fundamental corporate acts*

As is indicated elsewhere in this study,[15] courts generally will not grant relief to minority shareholders against charter amendments, mergers, or other fundamental acts unless those acts can be characterized as fraudulent or in bad faith. The vagueness of these standards leads to varying results in different courts on similar fact situations and is obviously an obstacle to a minority shareholder who seeks relief from a squeeze-play, especially as he usually must bear the burden of proving that the controlling shareholders or the directors have acted improperly.[16]

Statutory standards are badly needed to guide the courts in deciding whether to grant equitable relief to minority shareholders against fundamental corporate acts which affect them adversely. Certainly a minority shareholder should not be required to establish fraud in order to gain relief. A number of writers[17] have suggested "fairness" as the test to be used in determining whether to set aside recapitalizations; the same test might be applied to other fundamental corporate changes which adversely affect the rights of minority shareholders. The unfairness of a merger or other plan for fundamental change is of course much easier for a minority shareholder to establish than fraud or bad faith. Further, instead of requiring the complaining shareholder to establish unfairness, the burden might well be placed on the proponents of a plan to show that it is fair. This approach is taken by a Nebraska statute,[18] which provides that a preferred shareholder whose rights will be affected by a proposed charter amendment may apply to any competent court to en-

[14] N.C. Gen. Stat. § 55-50 (j) (Supp. 1959).

[15] See, e.g., §§ 3.03, 4.05, *supra*.

[16] Waldrop v. Martin, 237 Ala. 556, 188 So. 59 (1939); Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 Atl. 257 (1929); Robinson v. Pittsburgh Oil Refining Corp., 14 Del. Ch. 193, 126 Atl. 46 (1924).

[17] See, e.g., Dodd, Fair and Equitable Recapitalization, 55 Harv. L. Rev. 780, 791 (1942); Latty, Fairness—The Focal Point in Preferred Stock Arrearage Elimination, 29 Va. L. Rev. 1 (1942).

[18] Neb. Rev. Stat. § 21-1, 162 (1954).

join the amendment on grounds of fraud or unfairness, and that after a hearing the court shall enjoin the amendment if proponents fail to show that "to a reasonable probability" it is "fair, just, and equitable to all shareholders affected thereby."

Another approach might be to set up fact categories which create an inference of unfairness.[19] A statute might declare, for instance, that if a complaining shareholder can establish that a proposed plan for fundamental change will cause him substantial detriment, an inference of unfairness arises whenever either (1) there is no legitimate business reason for the action proposed, (2) the same legitimate business objective can be attained by an alternate plan which would not unduly prejudice the complaining shareholder, or (3) the asserted business objective is clearly secondary in importance to the majority's purpose of improving its position at the expense of minority shareholders.

§ 8.05. *Broadening appraisal statutes to cover any corporate transaction which substantially affects shareholders*

Attention has been called in another part of this study[20] to the facts that the appraisal statutes do not give a right of appraisal to shareholders in a corporation which purchases all of the assets of another corporation, even though the price paid is considered unreasonably high, and that in some states shareholders in a corporation selling all its assets are not entitled to appraisal. Such gaps in the appraisal statutes of course are sometimes utilized in a squeeze-play by majority shareholders to avoid paying a fair price for a minority interest.

The scope of the appraisal statutes should be broadened to allow a shareholder to have his shares appraised and purchased by the corporation whenever corporate action substantially impairs his position. Appraisal statutes should emphasize the substantial effect a corporate act has on a shareholder instead of conditioning appraisal on the form (i.e., merger, sale of assets, etc.) a squeeze-play

[19] This approach is suggested in Comment, Minority Rights and the Corporate "Squeeze" and "Freeze," 1959 Duke L.J. 436, 458.
[20] See § 4.06, *supra*.

takes.[21] As Dean Elvin R. Latty has suggested, "appraisal rights should be made to turn less on the shareholder finding himself in a different legal entity or in an expanded enterprise than on being drastically changed with respect to participation in earnings, liquidation and control."[22] Furthermore, in order to guard against a shareholder's overlooking the appraisal remedy, the corporation should be required to notify shareholders of their appraisal rights whenever a change is proposed which might give rise to those rights.[23]

§ 8.06. *British devices for protecting minority shareholders*

The British system for protecting shareholders against oppression is considerably different from the system prevailing in this country. A number of ideas for the reform of shareholders' remedies here can be gained from a study of the British system.

The rights of a shareholder in an English company to bring a derivative action are considerably narrower than those of a shareholder in a American corporation. The famous English decision of *Foss* v. *Harbottle,*[24] it is true, was a forerunner of the derivative action as it is known in this country in that the court in that decision recognized that a shareholder in some circumstances can assert the corporation's right to recover for wrongs to the corporation. However, that decision and subsequent British decisions[25] limited the shareholder's suit to one in which fraudulent or ultra vires acts have been committed against the corporation and the persons against whom relief is sought control the company and are preventing an action from being brought in the company's name. One effect of this limitation is to shield directors from shareholder suits based on their negligence.

However circumscribed the rights of a shareholder in an English company (as compared with the rights of his counterpart in an

[21] See Comment, Minority Rights and the Corporate "Squeeze" and "Freeze," 1959 Duke L.J. 436, 458.

[22] Latty, Some Miscellaneous Novelties in the New Corporation Statutes, 23 Law & Contemp. Prob. 363, 390 (1958).

[23] The North Carolina Business Corporation Act requires the corporation to notify shareholders of their appraisal rights when they are asked to vote on certain fundamental changes. N.C. Gen. Stat. §§ 55-100, 55-108, 55-112, 55-118 (Supp. 1959).

[24] 2 Hare 461, 67 Eng. Rep. 189 (Ch. 1843).

[25] E.g., Pavlides v. Jensen, [1956] Ch. 565, noted 19 Modern L. Rev. 538 (1956), 74 So. Afr. L.J. 86 (1957).

American corporation) to bring a derivative action, he is perhaps more than compensated by the greater statutory and administrative protection he enjoys. For example, the Board of Trade, a governmental agency charged with the general supervision of English companies, is empowered to appoint an inspector to look into the affairs of a company if there are circumstances suggesting that "persons concerned with its formation or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards it or towards its members" or that "its members have not been given all the information with respect to its affairs which they might reasonably expect."[26] After a report from its inspector, the Board of Trade may publish a report of the inspector's findings (a copy of the report then becomes admissible in any legal proceedings), may cause criminal proceedings to be brought, or may petition a court for a winding-up order or for an order under Section 210 of the Companies Act (this statute will be discussed in detail in a later section).

The Companies Act also empowers the court on a shareholder's petition to wind up a company, among other circumstances, if the court "is of the opinion that it is just and equitable that the company should be wound up."[27] That provision has been on the statute books in substantially its present form for over a hundred years. It has occasionally been used successfully to solve problems of dissension or deadlock in private companies. Thus, where the managing director was guilty of grave irregularities in making a secret profit, the court decreed a winding-up.[28] And, courts have ordered winding-up in a number of cases[29] in which such a complete deadlock of management had occurred that the company's activities would have been brought to a standstill if the court had not intervened.

Nevertheless, English judges, just like their American brothers, have been reluctant to decree a winding-up whenever that action was opposed by majority shareholders; and the books contain singularly few cases in which an oppressed minority in an English company secured a winding-up order. As a general proposition, the English courts heretofore have imposed a winding-up only if some

[26] English Companies Act, 1948, § 165. See also *id.* § 164.
[27] English Companies Act, 1948, § 222.
[28] *In re* Newbridge Sanitary Steam Laundry, Ltd., [1917] 1 Ir. R. 67.
[29] E.g., *In re* American Pioneer Leather Co., Ltd., [1918] 1 Ch. 556; *In re* Yenidje Tobacco Co., Ltd., [1916] 2 Ch. 426.

plain injustice was being done petitioner which could not be remedied otherwise than by a winding-up order.[30]

The Companies Act of 1948 contains a cautiously worded provision designed to broaden somewhat the courts' use of winding-up on "just and equitable" grounds and to make clear the power of a court to order a winding-up notwithstanding the existence of an alternative remedy. That provision reads as follows:

> Where the petition is presented by members of the company as contributories on the ground that it is just and equitable that the company should be wound up, the court, if it is of opinion,—
> (*a*) that the petitioners are entitled to relief either by winding up the company or by some other means; and
> (*b*) that in the absence of any other remedy it would be just and equitable that the company should be wound up;
> shall make a winding up order, unless it is also of the opinion both that some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy.[31]

§ 8.07. *Section 210 of the English Companies Act*

Perhaps the most interesting innovation of the Companies Act of 1948 was Section 210, the objective of which is to enlarge the protection afforded to minorities by providing an alternative remedy to winding up in cases of oppression. The Committee on Company Law Amendment which recommended the enactment of Section 210 pointed out that in many instances the winding-up of a company does not benefit the minority shareholders, because the break-up value of the assets may be small or the only available purchaser may be that very majority whose oppression drove the minority to seek redress.[32] Therefore, the Committee suggested that "the Court should have, in addition, the power to impose upon the parties to a dispute

[30] See Peppiatt, Statutory Protection of Minority Shareholders in English Limited Companies, 14 Bus. Law. 621, 629 (1959).

[31] English Companies Act, 1948, § 225 (2). For other statutory sections furnishing some protection to minority shareholders in rather narrow situations, see English Companies Act, 1948, § 72 (right of holders of 15 per cent or more of a class of shares to apply to court to have action modifying rights of shares canceled), §§ 206-208 (court approval required for "arrangements"), § 209 (2) (right of minority shareholders in a company 90 per cent of whose shares are acquired by another company to compel the acquiring company to buy their shares).

[32] Report of the Committee on Company Law Amendment (H.M.S.O., 1945), Cmd. 6659), para. 60, as quoted in Peppiatt, Statutory Protection of Minority Shareholders in English Limited Companies, 14 Bus. Law. 621, 631 (1959).

whatever settlement the Court considers just and equitable. This discretion must be unfettered, for it is impossible to lay down a general guide to the solution of what are essentially individual cases."[33]

The Committee's suggestion was accepted. Section 210 provides in part as follows:

> (1) Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) . . . may make an application to the court by petition for an order under this section.[34]
> (2) If on any such petition the court is of opinion—
> (*a*) that the company's affairs are being conducted as aforesaid; and
> (*b*) that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding-up order on the ground that it was just and equitable that the company should be wound up;
>
> the court may, with a view to bringing to an end the matters complained of, make such order as it sees fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise.[35]

During the first nine years that Section 210 was on the books, no shareholder succeeded in obtaining the court's assistance under it; although the possible availability of relief or perhaps threats to resort to the section may in many instances have tempered majority action.

In the Scottish case of *Elder* v. *Elder & Watson, Ltd.*,[36] decided in 1952, the court refused relief under Section 210 to petitioning shareholders on facts illustrating what is (in the United States at least) one of the most frequently used of the squeeze-out techniques, namely, the exclusion of minority shareholders from office and employment in the company. The company involved in that case had been brought into existence by the incorporation of a two-man partnership. At the time of the action under Section 210 the company had twelve shareholders, all descendants of the original partners. The company had a three-man board of directors; the two

[33] *Ibid.*
[34] The omitted material gives the Board of Trade also the right under certain circumstances to make such an application.
[35] English Companies Act, 1948, § 210.
[36] [1952] Sess. Cas. 49 (Scot).

petitioners were members of the board. The trouble started when one of the petitioners got into a violent quarrel with his brother, the third man on the board of directors. The brother thereafter persuaded holders of a majority of the shares to join with him in removing the petitioners as directors and in forcing their retirement or dismissal as secretary and factory manager respectively. Some time later petitioners tried to sell their shares to the company and its new directors, but their proposals were rejected.

Petitioners then resorted to Section 210, seeking an order for the purchase of petitioners' shares by the company at a stated price or at a price to be fixed by the court. The court dismissed the petition. Section 210 applies to oppression of members of a company in their character as shareholders: removal of shareholders from the directorate and from corporate offices and employment does not affect their interests as shareholders; and mere refusal of the directors to buy a member's shares is not oppression. There was no averment that the business had been or was being mismanaged. Thus the affairs of the company had not been conducted in a manner oppressive to part of the members. Furthermore, another condition to relief under Section 210 had not been met: under that section the court can act only if a winding-up order would be "just and equitable,"[37] and in this case the facts did not justify winding-up. Lord President Cooper commented: "Where the 'just and equitable' jurisdiction has been applied in cases of this type, the circumstances have always, I think, been such as to warrant the inference that there has been, at least, an unfair abuse of powers and an impairment of confidence in the probity with which the company's affairs are being conducted, as distinguished from mere resentment on the part of a minority at being outvoted on some issue of domestic policy."[38] Later he went on to say, "I do not think that a 'just and equitable' winding-up has ever yet been ordered merely because of changes effected in the board of directors or the

[37] The Draft Companies Bill for the State of Israel, § 151 (1957) provides as follows: "Any member of the company who considers himself oppressed by the conduct of the affairs of the company, may apply to the court, and the court may make such order as it thinks fit, whether for regulating the conduct of the company's affairs or for the acquisition of the applicant's shares by others or by the company, or otherwise, except an order for the winding-up of the company." Apparently this section gives the court power to grant other relief irrespective of whether a winding-up would be "just and equitable."

[38] [1952] Sess. Cas. at 55 (Scot).

dismissal of officers, and very strong grounds would be needed to justify such a step."[39]

The opinions in the *Elder* case indicated that Section 210 is indeed rather narrow in application and is not available for use in some of the most common dissension and deadlock situations. Thus Lord President Cooper commented that "the new remedy is not lightly to be accorded."[40] Lord Keith, referring to the types of cases to which Section 210 applies, stated: "Mere loss of confidence or pure deadlock does not, I think, come within Section 210."[41] At another point in his opinion he remarked that Section 210 did not suggest to him "that it includes mere domestic disputes between directors or members or lack of confidence between one section of members and another section in matters of policy or administration."[42]

Two cases decided in 1958, however, showed that Section 210 can be used to advantage in some dissension and oppression situations. The first case under Section 210 to reach the House of Lords, and also the first case in which the petitioning shareholder obtained relief under Section 210, was *Scottish Co-op. Wholesale Soc'y* v. *Meyer*.[43] In that case, a co-operative wholesale company (hereafter referred to as the "society") and two textile experts, Meyer and Lucas, organized a company to process and sell rayon materials. The society supplied most of the capital for the company, and Meyer and Lucas furnished the formulae, experience, and trade connections. Something over half the stock issued was allotted to the society and the remainder to Meyer and Lucas. Of the company's five directors, three were nominees of the society; Meyer and Lucas were the other two.

The new company became in effect a marketing subsidiary of the society. Meyer and Lucas, through their European connections, bought supplies of yarn, which were paid for by the society. The yarn was then processed and woven into cloth at one of the society's mills, which had not previously been used for the manufacture of rayon cloth. The cloth was then sold to the new company and by it dyed, finished, and resold.

[39] *Id.* at 57.
[40] *Id.* at 55.
[41] *Id.* at 59.
[42] *Id.* at 60.
[43] [1958] 3 All E.R. 66 (H.L.), noted 72 Harv. L. Rev. 761 (1959).

The new company's affairs prospered until, after a quarrel between the society's managers and Meyer and Lucas, the society formed a department to process and sell rayon cloth and adopted a policy of withholding cloth from the company except at uneconomical prices. Thereafter, the society's board of directors refused an offer of Meyer and Lucas to sell their shares at a negotiated price, recording in their minutes (this was not communicated to Meyer and Lucas) that the company had served its purpose and should be liquidated. The society's nominees on the company's board passively supported the society's decision to bring about the company's liquidation; they did nothing to prevent the company's business from declining.

Meyer and Lucas petitioned for relief under Section 210, and the court ordered the society to purchase their shares at a figure fixed by the court. The society appealed, and the House of Lords dismissed the appeal, holding that the society's conduct was oppressive and that, although complaining shareholders could only bring themselves within Section 210 by proving that the affairs of the company in which they held shares were being conducted in a manner oppressive to shareholders, the facts that the company was the society's subsidiary and the society's nominees on the company's board were participating in the society's oppression and passively neglecting the company's interests, rendered the conduct of the society and its nominees oppressive conduct of the company's affairs within the meaning of Section 210. In that connection, Lord Keith commented: "Misconduct in the affairs of a company may be passive conduct, neglect of its interests, concealment from the minority of knowledge that it is material for the company to know."[44] The House of Lords also indicated that whenever a subsidiary company is formed with an independent minority of shareholders, the parent company is subject to an obligation to deal fairly with the subsidiary. Finally, the House of Lords found no fault with the court's fixing of the transfer price of the shares: the price was properly fixed at the value they would have had if it had not been for the oppressive conduct.

The other 1958 case applying Section 210 was *Re H. R. Harmer, Ltd.,*[45] decided by the Court of Appeal. "Truly lamentable litiga-

[44] *Id.* at 85.
[45] [1958] 3 All E.R. 689 (C.A.).

tion," remarked Jenkins, L.J.,[46] of the suit by two shareholders asking for relief under Section 210 from the high-handed and oppressive conduct of their eighty-eight-year-old father. The father had founded a stamp business and had operated it successfully for many years. Eventually he incorporated it, giving to his two sons most of the nonvoting shares, which carried the major beneficial interest in the company, i.e., liquidation rights and rights to divisible profits, but retaining for himself and his wife most of the voting shares, which carried no right to participate in profits. The father and the two sons were all life directors of the company; in addition, the company's articles designated the father governing director but did not define the powers of the governing director or reduce the powers of the other directors.

The father, perhaps believing that his voting control entitled him to run the business just as he had before incorporation, assumed powers he did not have, disregarded resolutions of the board of directors, and in general interfered autocratically in the company's day-to-day affairs. Among other things, he opened a branch in Australia without authority, procured the appointment of directors whom he expected to vote as he directed, dismissed employees summarily, and told a prospective employee that one of the sons was "wrong in the head" and would not be with the company much longer. The petitioners asked for the following relief under Section 210: (1) a change in the company's regulations to confer voting rights on the nonvoting shares; or (2) an order requiring the father to sell his shares or at least his voting shares to petitioners; and (3) removal of the father from his office as director and alteration of the company's articles of association accordingly, on the company's undertaking to pay to the father and his wife such pension as the court might think proper; or (4) whatever order would be just. It was not disputed that the facts would justify a winding-up order under the "just and equitable" rule.

The court held that the petitioners had proved their case and entered an order under Section 210, but (with the agreement of the petitioners) not in the terms of the prayer in the petition. The order provided, *inter alia,* that the company should contract for the services of the father as philatelic consultant at a designated salary, that the father should not interfere in the company's af-

[46] *Id.* at 693.

fairs except in accordance with decisions of the board of directors, and that he should be appointed president of the company for life (the office, however, would not impose any duties or carry any rights or powers).[47] On appeal, the Court of Appeal held that relief under Section 210 had been properly granted. The affairs of the company had been conducted in a manner oppressive to the petitioners as members, not merely as directors. Even if the father's acts might lawfully have been done pursuant to formal authority from a general meeting, the petitioners were entitled to insist that proper procedure be followed. The fact that the sons had originally acquired the shares as a gift from the father (if that were a fact) was irrelevant. Further, even if the sons at the time they acquired their shares contemplated that the father would retain control, it could not be assumed that they knew the father would exercise that control irregularly and without giving any effect to their own life directorships. Finally, if the father had gotten no pecuniary benefit from what he did, his conduct would still have been oppressive: "If there is oppression, it remains oppression even though the oppression is due simply to the controlling shareholder's overweening desire for power and control and not with a view to his own pecuniary advantage."[48]

§ 8.08. *Irish proposals for modifying section 210*

A committee of the Government of Northern Ireland studying company law reform[49] has concluded that Section 210 of the English Companies Act is inadequate, suggesting that it needs to be radically reconstructed. The principal defect that the committee found was that the section is too closely linked with provisions dealing with the winding up of companies. The following excerpt from the committee's report sets forth the committee's thinking on this matter:

> The courts have construed the section as requiring a petitioner to show that the facts would justify the making of a winding-up order on the ground that it is "just and equitable" before he is entitled to relief. The cases show how difficult it is to satisfy a court that it is just and equitable

[47] [1959] J. Bus. L. 173.

[48] Jenkins, L.J., [1958] 3 All E.R. at 704.

[49] Report of the Departmental Committee on Company Law Amendment, Government of Northern Ireland, Cmd. 393, pp. 6-7, 10-12, reprinted in part in Corp. Prac. Commentator 33-38 (Feb. 1960).

to wind up a company. We know of no case in which it has been done on the ground that the directors were being paid excessive salaries or that excessive sums were being placed to reserve.[50] Nor do we know of a case where it has been done on the ground that the directors refused to admit a proposed purchaser of shares to membership.[51]

Apart from types of cases not here in question, an order to wind up on the ground that it is "just and equitable" must be founded on a lack of confidence in the management of the company "rested on a lack of probity in the conduct of the company's affairs" (Lock v. John Blackwood Ltd. [1924] A.C. 783, 788). "Lack of probity" is only another term for fraud. The burden of proving fraud or fraudulent intention is a very heavy one which the court requires to be discharged beyond a peradventure, and is only undertaken at the gravest risk as to costs. No one will assume it except in the clearest of cases. In our view shareholders are entitled to relief of some description long before any such point is reached.[52]

The committee made two other suggestions. One was that the protection of Section 210 should be extended to the personal representatives of a deceased shareholder. The other was avoidance of possible publicity which might adversely affect a company by making suitable rules of court providing for hearing of Section 210 applications in chambers.

§ 8.09. *Desirability of broadening remedies available in minority shareholders' suits*

On the whole, American courts have been singularly unimaginative in providing remedies for oppressed minority shareholders. Of course they have compelled dishonest majority shareholder-director-

[50] The report in the immediately preceding paragraph points out that the methods of oppression employed in private companies "are few, but distinctly and cruelly effective. We have already . . . pointed to one of the methods, which is to absorb profits in paying excessive remuneration to directors. Another method adopted is to place surplus profits to reserve without any good reason and without provision for any dividend so that the shareholders may become tired waiting for a dividend or die, thus constraining them or their representatives to sell the shares at a price fixed under the Articles of Association, on a basis unfair to a seller." Report of the Departmental Committee on Company Law Amendment, Government of Northern Ireland, Cmd. 393, p. 11.

[51] In Britain, shares in a private company are often subject to "consent restraints" which require director approval of a transfer of shares. If the directors arbitrarily exercise their power by refusing permission for any transfer even though there is no business reason for refusal, they deprive minority shareholders of the opportunity to dispose of their interests at a fair price to outsiders.

[52] Report of the Departmental Committee on Company Law Amendment, Government of Northern Ireland, Cmd. 393, p. 11.

officers to restore assets appropriated from the corporation, and they have sometimes set aside mergers and recapitalizations which were patently unfair to minority shareholders. On occasion they have even ordered the declaration of dividends. Remedies granted, however, have largely been stopgap in nature, providing relief against particularly flagrant acts by majority shareholders or by directors and officers, but have done little or nothing to protect minority shareholders against future oppression or new attempts at squeeze-outs. The remedies have generally failed to work toward a permanent solution of the problems created when a selfish and aggressive majority are searching for ways to oppress or eliminate a minority.

Many early cases laid down the rule that apart from statute courts do not have power to wind up a solvent corporation or to appoint a receiver to liquidate its affairs.[53] If this rule were to be applied, courts would not be able to order liquidation of a corporation at the suit of minority shareholders even though the majority had repeatedly committed fraudulent and oppressive acts and no other adequate remedy was available. Fortunately, in most of the decisions handed down in this century, the courts have usually refused to apply the old rule, recognizing that they have power to order liquidation in a proper case[54] and that on the facts of each case they should decide whether liquidation is the appropriate remedy. In some jurisdictions, however, courts draw a distinction between liquidation and dissolution, holding that a solvent corporation cannot be dissolved except by compliance with statutory formalities but that courts of equity even in the absence of a statutory grant of power can liquidate a corporation.[55]

Many modern corporation statutes authorize the courts in a suit by a shareholder or by the holders of a specified percentage of a corporation's shares to wind up or dissolve a corporation if its directors or majority shareholders are guilty of fraudulent conduct or if winding up is necessary to protect the rights of minority shareholders. The Pennsylvania Corporation Act,[56] for instance, provides

[53] People *ex rel.* Daniels v. District Court of Denver, 33 Colo. 293, 80 Pac. 908 (1905); Wallace v. Pierce-Wallace Pub. Co., 101 Iowa 313, 70 N.W. 216 (1897); Strong v. McCogg, 55 Wis. 624, 13 N.W. 895 (1882); Stevens, Corporations § 199 (2d ed. 1949).

[54] The classic work pointing out this reversal of position by the courts is Hornstein, A Remedy for Corporate Abuse—Judicial Power to Wind Up a Corporation at the Suit of a Minority Stockholder, 40 Col. L. Rev. 220 (1940).

[55] See Stevens, Corporations § 199 (2d ed. 1949).

[56] Pa. Stat. Ann. tit. 15, § 2852-1107 (1958). See also N.C. Gen. Stat. § 55-125 (a)(4) (Supp. 1959).

that the courts upon a petition filed by a shareholder may entertain proceedings for the involuntary winding up and dissolution of a corporation whenever "the acts of the directors, or those in charge of the corporation, are illegal, oppressive, or fraudulent, and it is beneficial to the interests of the shareholders that the corporation be wound up and dissolved." The California statute is not so broad, requiring that the proceedings must be brought by a shareholder or shareholders of at least one third of the corporation's outstanding shares.[57] These proceedings may be entertained when the "directors or those in control of the corporation have been guilty of persistent fraud, mismanagement, or abuse of authority, or persistent unfairness toward minority shareholders" or when "liquidation is reasonably necessary for the protection of the rights or interests of any substantial number of the shareholders, or of the complaining shareholders."[58]

The corporation act of every state should clearly grant power to the courts to dissolve a corporation at the suit of a minority shareholder, whenever majority shareholders or directors and officers under their control have acted fraudulently or oppressively. Whatever doubt is still cast by the early decisions on the courts' power to appoint a receiver or to grant dissolution and liquidation should be removed. Furthermore, the courts themselves might well consider giving somewhat less emphasis to the supposed harshness of dissolution as a remedy; perhaps they should grant dissolution upon a showing of less extensive and serious acts of fraud and oppression than formerly has been required. Finally, the corporation act should specify that litigation expenses of a complainant in a minority shareholder's suit for dissolution will be paid from the corporation's treasury rather than by the complainant, if he is successful in the litigation.

In many situations, remedies short of a decree of immediate liquidation probably would be effective. In litigation between shareholders in a two-man company, courts on occasion have issued a decree ordering dissolution if the shareholders failed to settle their differences within a specified time.[59] Giving the shareholders this last chance to resolve their differences and preserve a going business

[57] Cal. Corp. Code § 4650 (b).
[58] Cal. Corp. Code § 4651 (e), (f).
[59] Tri-City Electric Service Co. v. Jarvis, 206 Ind. 5, 185 N.E. 136 (1933); Schipper Bros. Coal Min. Co. v. Economy Domestic Coal Co., 277 Pa. 356, 121 Atl. 193 (1923).

—this time under the pressure of impending dissolution—seems to make sense; in any event such a decree can do no harm.

An interesting decree was issued by the Chancellor in a 1946 Florida case.[60] Minority shareholders had brought suit for an accounting for funds which the corporation had paid Deeb, its president, and business enterprises in which he was interested, and for the appointment of a receiver and the ultimate dissolution of the corporation. They had charged that Deeb, by causing the corporation to deal with other enterprises in which he was interested, had enriched himself to the detriment of the corporation, and that he had manipulated and mismanaged its affairs. The Chancellor denied the prayers for receivership and dissolution, but ordered the president to repay funds he had caused the corporation to disburse improperly. Furthermore—and this is the interesting part of the decree—he enjoined the corporation and Deeb in his capacity as president and director (1) from making any contract or assuming any liability or disbursing corporate funds in excess of $100 without first giving at least ten days' written notice to minority shareholders, and (2) from entering into any transaction with the other businesses in which Deeb was interested without the approval of minority shareholders.

On appeal, the Supreme Court of Florida held erroneous the restrictions which the Chancellor's decree had imposed on corporate transactions. The court recognized that doubtlessly the Chancellor had imposed the restrictions because he had wanted to prevent repetition of the improper transactions but had believed mismanagement had not reached a point that would justify the drastic remedy of dissolution. Nevertheless, the court concluded (1) that the restrictions would "bridle" the corporation, its directors, and its president by giving a veto to minority shareholders; (2) that they were not necessary to protect minority shareholders, because minority shareholders could enter a court of equity at any time to present complaints about corporate mismanagement; and (3) that, in any event, they violated the section in the Florida corporation act which provides that the "business of every corporation shall be managed by a board of . . . directors" and that, subject only to such limitations as may be provided in the act or the certificate of incorporation, "such board of directors shall have full control over the affairs of the

[60] Finn Bondholders, Inc. v. Dukes, 26 So.2d 802 (Fla. 1946).

corporation. . . ."[61] The court obviously believed that the procedure set up by the restrictions would as a practical matter be unworkable in a going business.[62]

The reasoning of the court is not at all convincing. In a corporation with widely scattered shareholders, it undoubtedly is impractical to require management to notify shareholders in advance of important corporate transactions and to obtain their approval. But the same objection is not valid in a corporation with only a few shareholders, all of whom reside near the corporation's principal place of business. If shares in such a local corporation were later to be transferred to persons living in distant places, the Chancellor could then modify his decree to avoid hardship. Moreover, the courts' suggestion that the minority shareholders were protected against future misdeeds, because they could always come back into court, hardly shows an understanding of the corporate facts of life. Information on corporate fraud and mismanagement is often difficult to obtain, and litigation in this area is expensive and uncertain. As is made clear in Chapters III-V of this study, a minority shareholder cannot easily protect himself against sophisticated squeeze-plays by determined majority shareholders. Applied to two- and three-man companies and perhaps applied to corporations with five or six shareholders, a decree is entirely reasonable and practical which requires a controlling shareholder who has been guilty of serious oppression or of repeated self-dealing to notify minority shareholders of proposed future transactions and to obtain their approval of transactions that are particularly susceptible of mani-

[61] Section 612.29, Florida Statutes 1941; Fla. Stat. Ann. § 612.29 (1956).

[62] In discussing the first restriction, the court stated: "For two years the corporation could not, under such a decree, engage in any business transaction involving more than $100 without serving written notice on all the minority stockholders, whoever they might be and wherever they might be, and awaiting the expiration of that period, and presumably until any protests they might make were considered and settled, before the directors could consummate those transactions.

. . . . "This procedure might well be only an invitation to inconsequential quibbling or to argument about business policies, and the advantage to the minority stockholders from such a course would not at all be commensurate with the disadvantage to the corporation." Finn Bondholders, Inc. v. Dukes, 26 So.2d 802, 804 (Fla. 1946).

In discussing the second restriction, the court stated: "The directors would be stripped of power to act until their transactions with Deeb had received the positive assent of the minority stockholders. By simply remaining silent the stockholders could veto any dealings with him. . . . In this case the dissonant minority would, so far as the transactions with Deeb were concerned, exercise more power than the directors. They could thwart any dealings with him, whether they were motivated by whim, caprice, or sound judgment." *Id.* at 805.

pulation to their detriment. The statutes should be amended to remove any possible doubt of the courts' power to issue decrees of this kind.

A 1956 New Jersey decision[63] found a lack of precedent no obstacle to a novel and ingenious equitable remedy. In that case, a 30 per cent shareholder brought a derivative action charging the individual defendants, directors and officers of the corporate defendant, with mismanagement and self-dealing. In the course of the proceedings, plaintiff was granted an order to inspect the corporation's records, but the firm of accountants engaged to do the work reported to the court that defendants had refused to cooperate and had imposed severe limitations on their attempts to inspect. Plaintiff then moved for the appointment of a receiver for the corporation.

The Chancery Division denied the application for a receiver and instead appointed for the corporation a "special fiscal agent" with full power and authority to check the propriety of all disbursements made by the corporation[64] or by another company (designated by name in the decree) owned by plaintiff and the individual defendants and controlled by the independent defendants. The order also provided that if the fiscal agent questioned any item of disbursement he should report to the parties and that whenever such a report was made any party would be privileged to apply to the court for relief.

On appeal, defendants claimed that the order of the Chancery Division was an unwarranted interference with the corporation's affairs. The Appellate Division of the Superior Court of New Jersey nevertheless affirmed the order, characterizing the Chancery Division's appointment of a fiscal agent in this case as "an ingeniously equitable *pendente lite* device undoubtedly hopefully contrived to avoid more stringent measures."[65] The court pointed out that substantial evidence had been presented in the Chancery Division to show the absence of adequate or standard accounting practices (in apparent violation of an agreement between plaintiff and individual defendants) and to show self-dealing by the individual defendants; that the Chancery Division quite obviously had decided not to appoint a custodial receiver in an effort to avoid injuring the business in its relations with the public and its customers (sub-

[63] Roach v. Margulies, 42 N.J. Super. 243, 126 A.2d 45 (1956).
[64] *Id.* at 245, 126 A.2d at 46.
[65] *Id.* at 246, 126 A.2d at 47.

scribers to Around the World Shopping Club); and that the appointment of the fiscal agent represented an effort to protect plaintiff without unduly hindering corporate business operations. Finally the court quoted[66] with approval language from the opinion in an earlier New Jersey case[67] setting forth the view that a court of equity "has the power of devising its remedy and shaping it so as to fit the changing circumstances of every case and the complex relations of all the parties."

In a dividend-withholding case,[68] a Texas appellate court directed the trial court to issue a unique decree designed to relieve minority shareholders of the necessity of repeatedly bringing successive suits in order to obtain dividends. In that case, the trial court had decreed receivership and liquidation. The appellate court eliminated the receivership and liquidation, substituting a mandatory injunction which required the corporation and its dominant shareholder-officer to declare "a reasonable dividend at the earliest practical date." Furthermore, the court's injunction ordered the payment of a reasonable dividend annually thereafter whenever not clearly inconsistent with good business practice, and the court retained jurisdiction of the case for a period of five years to insure compliance. This case was decided in 1955. No other decision granting similar relief has been found, but courts hereafter handling dividend-withholding cases might well consider following the example of the Texas court.

American legislators and judges should watch carefully English experience in the application of Section 210 of the Companies Act, not only to observe the types of cases to which the section is applied but also to see what kinds of remedies the English courts give and the success they have with them. Section 210 expressly says that the court may "make such order as it sees fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company. . . ." This section certainly seems to confer on the English courts much broader remedial powers than our courts have ever exercised.[69] The suggestion has been made that

[66] *Id.* at 246, 126 A.2d at 47.

[67] Sears, Roebuck & Co. v. Camp, 124 N.J.Eq. 403, 411, 1 A.2d 425, 429 (E. & A. 1938).

[68] Patton v. Nicholas, 154 Tex. 385, 279 S.W.2d 848 (1955).

[69] Note the remedy granted in *Re* H. R. Harmer, Ltd., [1958] 3 All E.R. 689 (C.A.), discussed *supra* § 8.07.

in some circumstances the court in applying Section 210 might give voting rights to holders of nonvoting shares;[70] and as a matter of fact, a court might undertake under that section to rearrange the whole share structure of the corporation.

§ 8.10. *Need for legal protection of contractual arrangements designed to prevent squeeze-outs*

Irrespective of what statutes are enacted or what judge-made rules are evolved for the protection of minority shareholders against squeeze-plays, participants in a business enterprise should be given a broad freedom to set up protective arrangements tailored to the particular business and to their own needs and wishes. Each business enterprise is of course unique. Legislation and judge-made rules, on the other hand, must almost of necessity "paint with a broad brush." Furthermore, in laying down rules, legislatures and courts must keep in mind many policy considerations—not just the protection of minorities. They must keep in mind, for example, such desiderata as the legitimate rights of majorities, the desirability of management structures which do not encourage deadlocks and corporate paralysis, and the need for flexibility in business structures so that enterprises can adapt to new situations and meet new problems and new opportunities.

Thus, even though great progress is made in evolving legislative and judicial safeguards against squeeze-outs, it is highly probable that a person entering a small business corporation as a minority shareholder will still want special charter or by-law clauses or a shareholders' agreement to assure him a particular role in corporate management or to provide protection he feels is needed in the particular business situation. The courts in the past, however, have been reluctant to permit departures from the traditional pattern of corporation management, and they have often upset charter or by-law provisions or other contractual arrangements which set up control patterns different from the orthodox scheme of corporation management.

Most often decisions striking down special control arrangements have been grounded on their supposed contravention of one or more

[70] Peppiatt, Statutory Protection of Minority Shareholders in English Limited Companies, 14 Bus. Law. 621, 637 (1959).

sections of the corporation act or on their supposed incompatibility with the scheme of corporation management and operation established by the corporation act.[71] Thus, and this is only illustrative, courts have often invalidated shareholders' agreements designating corporate officers and fixing their compensation on the ground that such agreements violate the statute (found in most corporation acts) which provides that the business of a corporation shall be managed by its board of directors.[72]

Judges and legislators, no less than other men, are creatures of their culture: its ideas are their ideas, its methods their methods, its limitations their limitations. A great number of our present judges and legislators are part of a legal generation which grew up in an atmosphere of corporate theory pervaded with the "concession theory" of corporate existence, under which the corporation is viewed as an artificial, fictitious being, and a corporate charter as a grant from the sovereign giving "life" to a new legal entity. Small wonder it is that such a generation is slow to approve unorthodox arrangements among shareholders which imply that a corporation is simply a group of businessmen voluntarily associating together, with freedom within broad bounds to determine by contract their relations among themselves.

In view of this deep-seated judicial opposition to new and unorthodox corporate management patterns, legislation is needed in many states to assure the validity of special charter and by-law provisions and shareholders' agreements needed to tailor the control pattern of small business corporations to particular business situations. Wherever necessary, the corporation acts should be amended to make clear that the rules there set forth on corporate management are not mandatory norms but instead are intended to apply only in the absence of contrary arrangement among the participants.

In some instances, amendment of statutes other than the corporation act may be necessary. For example, in many states, the arbitration statute should be amended to provide clearly for the enforcement of agreements to arbitrate future disputes (including disputes on management and policy questions). There is simply no justifi-

[71] See O'Neal, Close Corporations: Law and Practice § 5.06 (1958).

[72] See, e.g., Teich v. Kaufman, 174 Ill. App. 306 (1912); Clark v. First Nat. Bank of Ottumwa, 219 Iowa 637, 259 N.W. 211 (1935); Haldeman v. Haldeman, 176 Ky. 635, 197 S.W. 376 (1917); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

cation for refusing to give full effect to a contract among businessmen for the arbitration of intra-company disputes which may in the future arise out of the operation of their business.

§ 8.11. *A few suggestions for changes in the law of partnerships*

As has been pointed out elsewhere in this study,[73] the partnership form is exceedingly flexible, and partners may insert in the partnership agreement whatever provisions they conclude are necessary to protect themselves against squeeze-outs. Thus, from the viewpoint of avoiding squeeze-outs, few changes in the law seem indicated.

The fourteen jurisdictions which have not yet adopted the Uniform Partnership Act might well consider adopting it in order to clarify the legal principles applicable to partnerships in those jurisdictions. Furthermore, two sections of the English Partnership Act[74] seem relevant to the squeeze-out problem and perhaps should be added to the Uniform Partnership Act. One of those sections provides as follows: "If a partner, without the consent of the other partners, carries on any business of the same nature as and competing with that of the firm, he must account for and pay over to the firm all profits made by him in that business."[75] The other section states: "No majority of the partners can expel any partner unless a power to do so has been conferred by express agreement between the partners."[76]

[73] See § 7.13 *supra*.
[74] 1890, 53-54 Victoria, ch. 39.
[75] Section 30.
[76] Section 25.

Appendix. SELECTED SQUEEZE-OUT CASES

This appendix sets forth in somewhat detailed fashion the facts (insofar as they were obtainable) of four cases in which some of the owners in an enterprise tried to reduce or eliminate entirely the participation of other owners in the business. These cases were selected for inclusion because they illustrate clearly the more frequently used squeeze-out techniques and show in a rather dramatic way how a squeeze-play unfolds.

Case No. 1

Johnson v. *Mansfield Hardwood Lumber Co.*, 159 F. Supp. 104 (W. D. La. 1958), *aff'd*, 263 F.2d 748 (5th Cir.) *rehearing denied*, 268 F.2d 317, *cert. denied*, 361 U.S. 885 (1959).

This case demonstrates difficulties which can develop when stock in the corporation becomes dispersed after several generations among a large number of the descendants of the founders of the business. It also shows how the majority can squeeze the minority stockholders by misrepresenting facts about the business and withholding dividends. The plaintiff-minority shareholders in this case were successful in their efforts to recover their share of the proceeds obtained by the majority on the liquidation of the corporation shortly after the minority sold out its interest to the corporation.

The Mansfield Hardwood Lumber Company was organized by A. S. Johnson and N. D. Harrell in the early 1900's and was incorporated in Delaware in 1940. It owned and operated two lumber mills and retail outlets and lumberyards in five Louisiana, Arkansas, and Texas towns and held about 93,000 acres of timberlands in northern Louisiana and southern Arkansas. It also owned all the stock in a small railroad and two subsidiary corporations. In the later years of its existence its principal place of business was Shreveport, Louisiana, where it owned its general office building and other properties.

At the time that the facts relevant to this controversy began to transpire, A. S. Johnson's grandson, "Bud" Johnson, was president of the corporation. He held 851 shares, 320 of which were subject to a usufruct of his mother, and an unlimited proxy for the 751 shares owned outright by his mother. The first vice-president, Brown McCullough, held 322 shares and a similar proxy for seven shares owned by his wife. In 1951, at the request of Bud Johnson, Max Brown, who later became a member of the plaintiff-minority, resigned as second vice-president and was succeeded by Tom Long,

Johnson's brother-in-law, who held seven shares of his own and a proxy for his wife's 813 shares, 320 of which were subject to her mother's usufruct. Thus, these three officers controlled 2,751 shares of stock, 56 per cent of the 4,836 shares then outstanding. The plaintiff-minority group, whose stock ownership amounted to 1,567 shares, consisted of the following: Mrs. Hattie Johnson, A. S. Johnson's third wife and widow, and her daughter Mrs. Jeanette Johnson Jennette, who was also Bud Johnson's half-sister; Mamie Harrel, N. D. Harrel's widow; Mrs. Elizabeth H. Walker, Mrs. Ruth H. Mulkey and J. Allen Harrel, children of N. D. Harrel; and Mrs. Alice S. H. Brown, Mrs. Minette Velvin, and Max Brown. Hattie, Mamie, Minette and Alice were aged widows, largely dependent upon defendant corporation's dividends for their livelihoods. J. Allen Harrel was blind and equally dependent on the corporation.

During the time in question in this case, the board of directors was made up of seven members: Bud Johnson, Brown McCullough, and Tom Long, the officers, who were each active in the management of the corporation, and Charles L. Jennette, J. R. Heard, Sr., and J. Allen Harrel, all of whom were inactive in the management; the seventh member of the board was not named in the court's statement of the facts.

Sometime shortly before August, 1952, defendant's president, Bud Johnson, was offered $5,000,000 by the Roy O. Martin Lumber Company, Alexandria, Louisiana, for timberlands owned by the defendant in the neighborhood of Zwolle, Louisiana. These lands made up about 55 per cent of the defendant's total timber acreage and perhaps less than half of its total land values. The offer was rejected, and defendant's minority stockholders and directors were not advised that it had been received. At about the same time it was becoming apparent to defendant's officers that the defendant's prospect of future profits was not bright in comparison to the value of its land holdings. Apparently it occurred to them that the increasing demand for timberlands generated by large and growing paper manufacturing companies in the area offered promise of liquidation with a sizable gain. Their appetities were no doubt whetted by the example of Frost Lumber Industries, another Shreveport firm, which, by effecting a tax-free merger with Olin-Mathieson Chemical Corporation, reaped a sizable profit on the appreciation of its timber properties.

Between August and October, 1952, the officers consulted their accountant, asking his advice on the possibility of selling or otherwise disposing of the timberlands and the tax consequences of any such disposition. On August 29 and October 14 the accountant wrote letters to the defendant's officers advising against any such action because of the tax difficulties that would be encountered under the 1939 Code in the form of a double capital gains tax on both the corporation and the shareholders in a liquidation. Apparently the officers were not deterred from their plan to effect some sort of sale, for they began shortly thereafter to apply pressure to the minority shareholders with a view to forcing them to dispose of their stock to the majority at a price substantially less than the true value of the stock.

During this period the timberlands were carried on the defendant's books at their original cost—slightly less than $1,000,000—but their actual value, as the defendant's officers then knew as a result of the offer they had received and other transactions of which they were aware, was approximately $9,000,000. The 1952 annual report to the shareholders valued the total assets of the corporation at $3,044,513.98. The plaintiff-minority shareholders contended that they had placed considerable reliance on the company's balance sheets in evaluating their stock.

The defendant's sales and dividends records for the years immediately preceding and following the squeeze play involved in this case were as follows:

dividends	*per share*	*net sales*
1944	$ 6.00	(not available)
1945	6.00	(not available)
1946	7.00	(not available)
1947	9.00	(not available)
1948	24.00*	(not available)
1949	12.00	(not available)
1950	13.00	(not available)
1951	12.00	$2,765,775
1952	5.00	2,834,558
1953	4.00	3,271,056
1954	.00**	(not available)
1955	8.00	(not available)

* Partly due to the receipt of $160,594.68 insurance on the life of H. Ben Johnson, A. S. Johnson's son and former president.

** Treasury was exhausted by the purchase of the minority stock during 1953

The poor dividend performance of the corporation from 1951 through 1953 was attributed by the trial judge in part to the possibility that the defendant purchased large amounts of timber from outside sources as a result of the officers' desire to preserve the value of defendant's timberlands for purposes of later liquidation. No extraordinary capital expenditures were shown to have occurred during this period. On January 1, 1953, without considering the unrealized appreciation of defendant's timberlands, the defendant's "accumulated surplus," in funds and property, totaled $2,244,075.97, which sum was apparently set aside by the officers in preparation for the purchase of the minority's shares.

During most of this period the three officers of the defendant corporation were drawing total salaries from the defendant and its subsidiaries amounting to $67,000 per year or about $13.85 per share for each of the 4,836 outstanding shares. In addition, there was no limit upon their expense accounts. The district court in reviewing the facts of the case expressed the opinion that these salaries along with certain other facts indicated that the officers had been diverting the profits of the enterprise to their own use for a substantial period preceding the employment of the squeeze devices complained of here. As a further example of the officers' avarice, the court noted that one of the defendant's subsidiaries, the Reader Railroad Company, a twenty-five-mile public carrier used by the defendant in its timber operations, was shown on the defendant's books as having sustained a $3,715.35 loss in the year 1952 whereas its gross earnings were in fact $102,400.00. The railroad company paid salaries of $10,000 and $3,600 to McCullough and Johnson respectively.

In addition, the trial court noted that the Shreveport Lumber Sales Company, a concern which was organized by the six members of the majority along with two or three of the defendant's salesmen and which was located within the defendant's office and operated at the defendant's expense, served the defendant in the capacity of a brokerage agency and charged a 5 per cent commission on all sales for its supposed services. In 1950, 1951, and 1952 this company billed the defendant for approximately $135,000 annually, a little less than $28 per share per year. Apparently the minority shareholders never knew of the existence of this firm, and no shareholders' or directors' resolution of record ever authorized the arrangement.

The attempt to eliminate the minority began in 1953. Johnson and McCullough informed the various members of the minority that because the president and second vice-president were young men with families to support and the future to think of they were more interested in drawing their income in the form of salaries and putting whatever profits were left into the expansion of the business by the purchase of more timberlands, a reforestation program, and capital improvements for the lumber mills. They indicated that they preferred to avoid double taxation by cutting down on dividends and building their equity in the corporation. They pointed out that these goals could be accomplished over any objection which the minority might have. They further assured the shareholders that there was no plan for liquidation under consideration and emphasized at all times that their intention was to make lifetime careers for themselves and their children and to maintain the business as a going concern.

On the basis of these representations, all of the plaintiff-minority group except Mrs. Hattie Johnson and Mrs. Jennette sold their stock to the corporation for $350 per share. Among this group was Max Brown, who was employed by the corporation as a mill manager at $15,000 per year and who owned 65 shares. Having been an officer in the past and knowing the company's general situation, he had a fairly good idea that his stock was worth at least $2,000 per share. He was told that the president wished him to "turn in" his shares for $350 apiece and was assured that the company was not to be liquidated so that there was no possibility of his realizing their true worth. Because his job with the corporation was his only source of income in the absence of regular dividends, he decided to sell his stock as ordered and keep his employment. As it later developed, he lost the job also. Subsequently he again became a shareholder, having been made a director and issued one qualifying share, which he immediately endorsed back to the company. In the capacity of holder of that one share, he voted to ratify the purchase of the minority's stock, including his own, and in favor of the liquidation. After the liquidation he received one year's salary as severance pay.

Mrs. Johnson and Mrs. Jennette held between them approximately 1,300 shares. Both of these ladies, the former quite aged, relied almost entirely for their livelihood on the dividends paid on their shareholdings. Bud Johnson visited Mrs. Jennette's husband

and discussed with him the future of the company, emphasizing the details of the dividend situation but never offering to purchase the stock of the two ladies. Mrs. Johnson consulted McCullough, who confirmed everything Johnson had told Jennette. He refused to advise her, but sent her to the firm's accountant, who in turn refused to advise her one way or the other. He did, however, point out to her her dependence on the dividends and reminded her that the majority was in a position to carry out its plans over her objection. He also hinted that she might at some time in the future be compelled to sell her stock for even less than the current going price. After some negotiation Mrs. Johnson and Mrs. Jennette sold their stock for $400 per share on November 14, 1953.

This last purchase was necessary to give the officers the two-thirds majority they needed to liquidate the corporation. They now had 1,928 of the 2,085 minority shares. Johnson then began his selling campaign. He negotiated extensively with a number of potential purchasers but did not obtain a satisfactory offer. In August, 1954, the new Internal Revenue Code became effective and assured the majority of single capital gains treatment on the sale and liquidation.

By July, 1955, the defendant had entered into a contract to sell its assets with the exception of mineral rights on some 60,000 acres of its land. The purchaser was to be Robert Gair Company, with which Southern Advance Bag and Paper Company, with which Johnson had originally negotiated, had merged. The terms were to be $4,832,530.34 in cash, the balance secured by a mortgage note, payable in five years, with interest at 3 per cent per annum. A special stockholders' meeting on September 26, 1955, unanimously approved this sale. At this meeting Mrs. Eleanor Johnson, Bud Johnson's mother, Mrs. Long, Johnson's sister, and Mrs. McCullough, wife of the first vice-president, voted their stock for liquidation, the only time they voted except by proxy in the history of the case. It was agreed that the mineral rights retained to the property sold were to be distributed to the remaining shareholders pro rata.

The news of the proposed sale reached the newspapers, and the former minority shareholders made inquiries of Johnson and the other officers, who attempted to make it appear that the liquidation had come about as the result of a sudden discovery that the property disposed of had values never before known to exist. About this time

Max Brown, now a director and still an employee of the corporation, tendered a check to Johnson for the amount he had received for his stock, and asked that he and others be permitted to repurchase their stock and share in the liquidation. Johnson refused, and Brown subsequently voted his one share in favor of the liquidation. Allen J. Harrel wrote Johnson the following poignant letter:

Dear Bud:

In view of the statements and the promises that you made to me at the time that you were trying to obtain our stock in M. H. L. Co. I was not only surprised but virtually dismayed to learn that you are now in the process of liquidating the company at an enormous profit to those that are left in the company. The statements referred to are that you wished to obtain this stock so that you could better cope with the tax situation by absorbing most of the earnings by paying it out in salaries and in that way avoid double taxation, that you and Tom were both young and both had children that would carry on the business and it would never be sold or liquidated, also because of the first reason mentioned that you would pay little or no dividends for a long time to come. One promise I especially remember was that you would not offer or pay anyone more than you were going to pay us. This promise was violated soon after you made it. These circumstances forced us to accept your offer and let you have what stock we had left. I feel that we have been wronged by your action in this matter and you are morally obligated to do something about it. The honorable thing to do would be for those of you that are left to agree to compensate us for the sacrifice that we made in letting you have the stock. The company now is virtually a family affair so am sure that it would be an easy matter for you to get together on something like this. The price that you are getting for the company would enable you to do this and still leave all of you more than you could ever use and in the long run feel that your conscience would be a lots clearer than it will ever be if you do not do something about it. I am sure that it can be worked out from a tax angle also when the Revenue Department is informed that this is a way of taking care of those that sold because of statements and promises that you made. I do not know if you realize just how the M. H. L. Co. came into existence or not but it was first started back in 1901 when after your grandfather, Mr. Johnson failed in the mercantile business here my father and his sister, who was the wife of Mr. Johnson, put up money to start the Lewisville Lumber Co., they later moved to Stamps and thence to Louisiana. Both men that originally started this company have widows and children living and are certainly entitled to a better deal than they have gotten under the deal that they were virtually forced to make with you. I hope that after you reflect over this matter and then consider the part that my father and Mr. Johnson had in bringing the M. H. L. into being

and promoting it to the point where their successors took over, you and those connected with you will decide to do the right thing about it. Please let me hear from you as soon as convenient for you to do so. Personal regards to Brown, Tom and yourself.

Yours very truly,
J. A. HARREL.

Johnson rejected the unfortunate old man's request that the minority be restored to its former position.

Johnson and McCullough at this time made every effort to close the sale and complete the distribution of the corporation's assets on liquidation. On May 25, 1956, the sale to Robert Gair Company was closed and the following prices were received for the principal assets:

Zwolle Mill	$ 75,000.00
Winnfield Mill	285,000.00
Stock in the company's subsidiaries	500,000.00
Reader Railroad	39,100.00
Timberlands	8,632,530.34
Total	$9,531,630.34

This figure, added to the value of the mineral rights retained, made the corporation worth well over $10,000,000, or approximately $2,068 for each of the shares in the company. Thus the extent of the wrong to the minority, which received $350 or $400 per share, is apparent.

In August 1955 Mrs. Johnson and Mrs. Jennette first consulted an attorney, who investigated the case and concluded that there was not enough evidence to warrant proceeding further. Finally, however, they found an attorney who would take the case, and within one month after the sale was closed he was ready to commence discovery proceedings. Thereafter suit was filed asking for an injunction restraining the majority from further disposing of the corporate assets and for rescission of the stock sales.

The trial court found actual fraud on the part of the officers of the corporation, but also found that even without actual fraud the defendants would remain liable because they had breached their fiduciary duties in failing to advise the plaintiffs of the material facts concerning their plans for the future of the business and the

value of the stock. As another ground for its decision the court found that the consideration received for the minority's stock was not "serious" within the meaning of the Louisiana Civil Code. The court rejected the defendant's argument that the fraud of the officers was ultra vires and that an action against the corporation was not the proper remedy. It also rejected the contention that plaintiffs Hattie Johnson, Mrs. Jennette, and Max Brown had ratified the action of the majority. The court granted the injunction, rescinded the sale of the stock, and ordered a full and accurate accounting.

On appeal, it was held that there was no error in failing to join the officers of the corporation because they were not indispensable parties. The court of appeals agreed that there was a breach of fiduciary duty owed to the stockholders and that business duress had been applied to Max Brown, Mrs. Johnson, and Mrs. Jennette. However, the court of appeals held that it was error for the trial court to find that actual fraud had been established. The court further indicated, "in fairness to defendant's officers," that the trial court was "clearly erroneous in its findings as to the Shreveport Lumber Sales, in commenting on the excessiveness of the officers' salaries and expense accounts, and in holding 'that the officers probably bought a large amount of timber from outside sources, instead of cutting from defendant's timberland, thus maintaining their value for purposes of later liquidation.'" The district court's judgment was affirmed.

The court of appeals subsequently, in an opinion on rehearing, held that the district judge was not clearly erroneous in holding that there was "actionable fraud" under Article 1847 of the Louisiana Civil Code. The court preferred to rest its conclusion on the broad scope of fraud in Louisiana rather than on a debatable choice of law rule which would require the court to seek the proper rule concerning the fiduciary duty of officers, directors, or majority stockholders in the state having extensive contacts with the corporation rather than in the state of incorporation, in this case Delaware. The necessity for this clarification on rehearing was brought about by the peculiar limitations on equity jurisprudence in the state of Louisiana. On reconsideration, the court was satisfied that the intent necessary to establish "actionable fraud" in Louisiana was proved.

Case No. 2

Brown v. *Dolese,* 154 A.2d 233 (Del. Ch. 1959), *aff'd sub nom. Dolese Bros. Co.* v. *Brown,* 157 A.2d 784 (Del. Sup. Ct. 1960).

In this case an ambitious corporation president succeeded in eliminating a substantial minority interest and thereafter, although only a minority shareholder himself, very nearly succeeded in appropriating to his own use the most profitable portion of the business. In carrying out his scheme he used corporate funds to finance his acquisition of the minority shares and imposed upon the love and trust of his mother, brother, and sisters, the remaining shareholders, to accomplish his object. He succeeded in concealing his wrongdoings from 1946 until 1958, when suit was finally filed. The significant aspects of this case are the ability of the president to acquire almost complete control over the stock of all the remaining shareholders; his flagrant abuse of proxies, powers of attorney, and his position as trustee for one of his sisters; and finally his strict adherence to the forms of corporation law. The case was appealed to the Supreme Court of the State of Delaware after a denial of the defendant's motion to dismiss the complaint, and it was considered on the facts alleged by the plaintiffs. In remanding the case for further proceedings the court held that the facts were sufficient to state a cause of action. The statement of facts which follows is taken from the allegations of the plaintiffs:

The Dolese Brothers Company, a Delaware corporation, was formed by the brothers John, Peter, and Henry Dolese, none of whom was living during the period which concerned the court in this case. At the time in issue John's widow, Elsie, and their daughter, Mrs. William Schofield, owned 1200 shares, 40 per cent of the outstanding stock of the corporation. The remaining 60 per cent of the stock, or 1800 shares, was owned by the heirs of Peter, including his widow, Jane, their sons Roger and David, and their two daughters, Mary and Margaret. The individual interests of each shareholder on September 9, 1946, appear in the following table:

Heirs of Peter Dolese	
Roger Dolese	600 shares
Roger Dolese, trustee for Mary Dolese Courtis, *et al.*	200 shares
Margaret Dolese Brown	400 shares
David Dolese	400 shares
Jane Dolese	200 shares
Heirs of John Dolese	
Elsie Dolese	200 shares
Gertrude Dolese Schofield	400 shares
Gertrude Dolese Schofield, trustee	600 shares
total outstanding shares	3,000 shares

All the shares of the company were held subject to an agreement dated February 6, 1942, in which each shareholder agreed not to sell his shares without first offering his stock to the other shareholders and the company.

The corporation's business was the quarrying and selling of limestone, gravel, and other materials and the operation of a transit-mix concrete business in Oklahoma City, Oklahoma. At the conclusion of World War II, the transit-mix concrete business became the most profitable of the company's operations. The company's business prospered for a number of years, and by 1946 the company had amassed substantial assets. During the period in issue it owned more than $1,000,000 in "quick assets," including at least $870,000 in cash, and had extensive credit resources which would have enabled it to borrow large sums without difficulty.

For a period prior to September, 1946, Roger Dolese and William Schofield, husband of John's daughter, operated the business as president and vice president-treasurer respectively. Both men served as directors. Roger, owning 600 shares outright and 200 shares as trustee for his sister Mary, actively represented the 1800 shares owned by him and his immediate family. Schofield actively represented the 1200 shares owned by his wife and mother-in-law.

By the time Roger's plan began to take shape, he had already succeeded in dominating the shareholders whom he represented to the extent that he could carry out his will. He had obtained on November 20, 1945, a power of attorney from his sister Margaret, which he procured by representations that he would use it for her

benefit since she was ignorant of the ways of the business world. He obtained powers of attorney from his mother and brother by similar devices. All of these powers purported to be irrevocable until March 16, 1951, though they were given without consideration and were not coupled with any interest in Roger. The powers gave to Roger the right to vote, sell, or mortgage the stock and to receive the proceeds of any sale or mortgage, and purported to foreclose the owners of the stock from exercising any of their rights with respect to it. At a stockholders' meeting on September 9, 1946, Roger consented to allow Margaret to vote her own shares but indicated that it would be necessary for her to sign a "Temporary and Limited Suspension of Power of Attorney" before she could do so. Margaret and the others were apparently kept in ignorance of their right to revoke their powers of attorney.

In 1945 and 1946 dissension over policy matters led to a dispute between Roger and Schofield. The minority threatened litigation, but after negotiations they agreed to sell their 40 per cent interest for $725 per shares or $875,000. The plaintiffs in the instant action alleged that this price was substantially less than the real value of the stock.

Roger took this offer to the members of his family and, alleging that the corporation was not in a position to purchase the stock, made it clear that the family would have to make the purchase if it were to be made. The members of the family all declined to participate in the purchase because they were without sufficient resources and were unwilling to borrow the necessary sums. Both Margaret and Mary later stated that had they known the company was in a position to purchase the stock they would not have opposed such a purchase.

At a stockholders' meeting on September 9, 1946, Roger consolidated his controlling position by having himself and his mother re-elected as directors and George Howard elected as a director to replace William Schofield. Howard was made vice-president and treasurer, and Dwight Hitt was named secretary of the corporation. Both Howard and Hitt were subservient to Roger.

About this time Roger organized a new corporation, the Dolese Company, with himself as the sole stockholder. On November 19, 1946, the Dolese Company entered into an agreement to purchase

the Schofield stock for $870,000. At this time the Dolese Company had only nominal assets.

On November 26 Roger called and held a special meeting of the board of directors of the Dolese Brothers Company, which he and Howard alone attended and at which a resolution was adopted under which Dolese Brothers waived its right to purchase the stock of Elsie and Mrs. Schofield under the agreement of 1942. Also at this meeting a waiver of purchase rights was executed and signed six times by Roger in the following capacities: as president and on behalf of the company, individually, as trustee for Mary, and as attorney-in-fact for his mother, David, and Margaret.

On November 27 Roger held a Dolese Brothers stockholders' meeting without sending notice of the meeting to Margaret, David, or his mother. Acting as trustee for Mary and as attorney-in-fact for Margaret, David, and his mother, he waived notice of the meeting in their behalf and attended as their representative. Howard attended the meeting as proxy for the Dolese Company, even though that company had not yet paid for the minority stock which it had contracted to purchase.

At this meeting it was announced that the Dolese Company had purchased the 1200 shares owned by the minority branch of the family. The meeting then proceeded to adopt the following resolutions: (1) that there be a partial liquidation of the Dolese Brothers Company by a distribution of 40 per cent of the Dolese Brothers Company assets to the Dolese Company upon the surrender for cancellation and retirement of the 1200 minority shares; (2) that certain specific assets be so distributed, including $567,693.05 in cash and designated physical assets having a book value of $303,862.48; (3) that the 1200 shares of stock so received be canceled and retired; and (4) that the authorized capital of the corporation be reduced from 3000 to 1800 shares.

Thereafter, the lucrative Oklahoma City transit-mix business and the stated amount of cash were transferred to the Dolese Company. Roger borrowed $350,000 from the Liberty National Bank of Oklahoma City, Oklahoma, using as security his 600 shares of Dolese Brothers Company stock and a chattel mortgage on the transit-mix concrete assets which had been transferred to the Dolese Company. This $350,000 he immediately loaned to the Dolese Company, enabling that company to pay the minority shareholders of Dolese

Brothers Company the promised $870,000 for their stock. Dolese Company surrendered the 1200 shares to Dolese Brothers, which proceeded to cancel them and reduce its authorized capital in accordance with the shareholders' resolutions.

On November 29, 1946, after these actions had been taken, Jane Dolese, Roger's mother, and David and Margaret executed a certificate stating that they had read the minutes of the stockholders' meeting and ratifying and confirming all the action taken. The document also alleged that Roger had discussed these matters with them prior to the meeting and that they had advised him that the action proposed was satisfactory to them. Margaret later contended that she understood from Roger that he had acted at great personal sacrifice and that the steps taken were necessary for tax purposes and to protect the firm from litigation which might be instituted by the minority.

Thereafter until August, 1955, Roger ran both companies and furnished no financial statements of either company to the Dolese Brothers shareholders. He failed to send notices of meetings and allowed the shareholders to believe that the dividends they received represented their shares of the entire profits of the business as it had existed prior to the transactions of 1946. In August, 1955, Roger offered to purchase from Margaret and from the trust for Mary the Dolese Brothers stock, and in the course of these negotiations he furnished financial statements of the business. It was at this time that Margaret and Mary began to understand what had happened. Roger was successful in persuading his mother and brother to accept offers for the purchase of their stock at book value. By the time the case was commenced Roger owned or had voting control of 1200 of the 1800 outstanding shares of the Dolese Brothers Company.

A derivative suit was filed in Delaware Chancery Court on May 8, 1958, for the purpose of recovering for Dolese Brothers Company and its stockholders assets and property of the company wrongfully converted and misappropriated by Roger and profits gained by Roger from the use of said assets and property from 1946 to 1958.

The Supreme Court of the State of Delaware, in affirming the Vice-Chancellor's denial of the motion to dismiss, held that Roger's misuse of corporate funds, his use of proxies to promote his "peculiar personal interest," and his unilateral action in waiving the corporation's expectancy in the purchase of the minority's stock were suffi-

cient legal wrongs to support the plaintiff's case. The court further held that Roger's fraud in the use of his powers to vote his family's stock prevented him from asserting that the stockholders should not be allowed to repudiate the action of their agent. The court stated that the wrong done by Roger to his family was not merely a personal wrong, which could be redressed only by a suit against him as an agent or trustee, but was also a corporate wrong which could be redressed in the name of the corporation. The court declined to hold that the trustee's vote at a corporate meeting was binding on the corporation and that the beneficiaries of the trust had only an action against the trustee for his abuse of his duties as fiduciary. Roger's argument that he had not been sued in his capacity as trustee and that therefore an indispensable party was missing was likewise rejected. And, finally, it was held that whether Margaret's ratification of the events of the stockholders' meeting of November 27 was executed with full knowledge of all pertinent matters was a question of fact to be resolved on remand. The case was sent back for further proceedings.

Case No. 3

Gaines v. *Long Mfg. Co*,. 234 N.C. 331, 67 S.E.2d 355 (1951), and *Gaines* v. *Long Mfg. Co.*, 234 N.C. 340, 67 S.E.2d 350 (1951).

This case history demonstrates how undercapitalization and the issuance of a small number of shares can give a significant proprietary interest to a nominal shareholder. The difficulty of effecting a squeeze-out by diluting the minority's interest through the issuance of additional shares is revealed here. Whether plaintiff would have had a better case or a worse one if he had not had pre-emptive rights is an interesting topic for speculation. The case also illustrates a peculiar example of the "dividend squeeze" where the initial undercapitalization of a successful corporation eventually makes the payment of dividends based on par value of the shares incongruous when compared with the size of the corporation's surplus and earnings. The case was heard on the basis of the plaintiff's allegations, but facts appearing in the defendants' affidavits have been included here to give a better picture of what the actual facts may have been. Because the case was settled before trial on the merits, the following discussion contains factual issues which were never resolved.

In 1941 W. R. Long moved to Tarboro, North Carolina, and began as sole proprietor a business for the sale, distribution, and repair of farm machinery and equipment. He employed R. M. Gaines in 1942 or 1943 as a bookkeeper and accountant with possible additional duties as office manager, supply parts manager, and floor salesman.

The business prospered in the early years, and lucrative distributorships and sales agency agreements were established in 1943 and 1944. Long spent from $7,000 to $8,000 for advertising and in setting up dealers and distributors in 1944 and between $15,000 and $17,000 for these purposes in 1945. In the latter year, he designed and began to manufacture heaters, floor furnaces, and tobacco

curers; by the end of 1946, the manufacture of oil tobacco curers under the names "Long Blue Flame Curers," and "Long Silent Flame Curers" was well established.

In 1946 Long decided to form two corporations, one to sell farm machinery and appliances and handle his retail business, and the other to concentrate on the manufacture of tobacco curers and floor furnaces and maintain the organization of dealers and distributors which had been built up for these products. Accordingly, on September 13, 1946, the Long Manufacturing Company Inc., was organized with an authorized capital of $100,000. Stock was issued as follows:

W. R. Long	7 shares @ $100 par =	$ 700
J. G. Long	1 share @ $100 par =	100
R. M. Gaines	2 shares @ $100 par =	200
	10 shares @ $100 par =	$1,000

These shares were paid for in cash by each of the shareholders.

On December 30, 1946, the Long Supply Company, Inc., was incorporated with an authorized capital of $100,000. This company took over the assets and liabilities of the proprietorship. Stock was issued as follows:

W. R. Long	745 shares @ $100 par =	$74,500
J. G. Long	5 shares @ $100 par =	500
R. M. Gaines	15 shares @ $100 par =	1,500
	765 shares @ $100 par =	$76,500

J. G. Long and R. M. Gaines paid cash for their stock in this corporation. It is uncertain whether Long himself paid cash for all his stock, or only for 480 shares, receiving the remaining 265 shares in return for the business, or whether he received the entire 745 shares for the Supply Company. Long and Gaines were elected president and secretary-treasurer respectively of each corporation.

Long contended that at the time of establishing the corporations

> it was understood and agreed . . . that the business of W. R. Long was to be continued under the two corporations and that it was his business, and that no additional stockholders were desired or sought at that time and that . . . Gaines, being an employee of W. R. Long, was requested to become one of the stockholders of both corporations for the purpose of securing the necessary three persons to secure a charter. At no time was

the $200 put into [Long Manufacturing Company] by . . . Gaines considered by anyone as being a sale to him of a one-fifth interest in the manufacturing and distributing business which W. R. Long had built up over the years preceding the date of incorporation.

Long pointed out that he had contributed extensive intangible assets and value as a going concern to the Manufacturing Company without receiving payment.

Long claimed that in 1947 a total of $140,987.29 was advanced to the Long Manufacturing Company by Long and the Long Supply Company to carry on its business operations but that by the end of the fiscal year on October 31, 1947, the debt due amounted to just $29,077.69. Gaines stated that

money advanced by Long Supply Company to purchase land, buildings, etc., was repaid the first year; that as a matter of fact the Long Manufacturing Company, Inc., had made advances to the Long Supply Company, Inc., in 1947, and that it was not until 1948 when the Company lost some money on the manufacture of tractors (a venture against which . . . [Gaines] protested) that any substantial advancement was obtained from the Long Supply Company.

Long stated that the debt to Long Supply Co., Inc., was temporarily paid in full early in 1948 but that the pressure of tax installments forced a reborrowing so that by October 31, 1948, the debt was $70,-768.92. This debt increased to $93,608.58 in 1949, and $100,338.06 by October 31, 1950. At the end of each of the first four years of its existence the financial status of the Long Manufacturing Co. was as follows:

as of Oct. 31	*Gross sales*	*net profit after taxes*	*current liabilities**
1947	$2,024,000.00	$193,707.62	(not available)
1948	(not available)	32,142.57	101,463.04
1949	(not available)	19,317.43	102,505.34
1950	$1,117,799.53	50,367.05	110,815.71

* Excluding debt to Long Supply Company mentioned in preceding paragraph.

On October 31, 1950, the earned surplus of the corporation was $295,387.47, and the book value of each share of stock was $29,638.74. The corporation's cash on hand was $146,124.92.

Long claimed that by December 31, 1950, the corporation's cash on hand had diminished to $3,796.26 and that accounts payable

had increased to $159,084.50 in addition to the debt to Long Supply Company. He further claimed that on January 31, 1951, cash was $35,582.61, accounts payable other than the Long Supply account were $224,739.85, and the debt to Long Supply had increased to $117.287.97. In addition, there were said to be a number of sizable contingent liabilities. This alleged vast and rapid change in the corporation's circumstances was attributed to preparation for an increase in production in response to a communication from the Department of Agriculture and to the seasonal nature of the tobacco curer business.

Long contended that the cash and working capital situations were serious enough to lead him to apply for a bank loan of $25,000 for the Manufacturing Company in January, 1951, for the purpose of carrying out this expansion during the 1951 season. The loan was approved by the Security National Bank on the condition that Long and the Long Supply Company endorse the note. The bank required these endorsements because of the debt to the Long Supply Company, which was principally secured by a deed of trust upon the real and personal property of the Long Manufacturing Company, and because of the firm's contingent liabilities. Also in January, 1951, Long applied for a $75,000 loan for the company from the Wachovia Bank and Trust Company. He advised the loan committee that the corporation proposed to issue its remaining authorized stock and to liquidate the indebtedness to the Long Supply Company with the proceeds of this issuance. The committee agreed to extend a seasonal loan of up to $75,000 on the endorsement of Long when the additional stock had been issued and the debt liquidated and canceled.

This was the situation when the corporate actions to which Gaines objected were initiated on January 8, 1951. Previously, on June 30, 1949, Gaines had resigned from his executive positions in both corporations, allegedly on account of Long's management and certain conduct of J. G. Long, and had sold his fifteen shares of stock in the Long Supply Company to Long for their book value of $3,000. Gaines claimed that subsequently, in the fall of 1950, Mr. R. E. Wiggins, the auditor for both firms, proposed terms to him on which he, Gaines, might withdraw from Long Manufacturing Co. Wiggins suggested that since Long Supply Company had supplied the capital for Long Manufacturing Company's growth,

it would be fair for Long Manufacturing Company to issue enough stock to Long Supply Company at $100 per share, the par value, to pay the $100,338.06 debt. Wiggins also proposed that thereafter the book value of all the stock could be calculated and Gaines paid book value for his two shares. Gaines refused this offer and denied the assertion that the Long Manufacturing Company had made its money on capital advanced by Long Supply Company.

On January 8, 1951, at the annual meeting of the stockholders of the Long Manufacturing Company, two resolutions were passed over the protest and negative vote of Gaines. First, a 6 per cent dividend was declared on the outstanding ten shares of stock, to be paid to shareholders of record as of January 8, 1951. This amounted to a total of $60 out of a surplus of $295,387.47, the remainder of which was allocated to working capital in accordance with N. C. Gen. Stat. § 55-115 (1950). The second resolution directed the issuance and sale, at the $100 par value, of the 990 remaining shares of authorized but unissued capital stock. Pre-emptive rights were accorded to each stockholder of record as of January 8 to subscribe within thirty days for 99 shares of the stock for each share then held. The resolution recited as the reason for the issuance of this stock the fact that

> in 1946, when the Long Manufacturing Company was incorporated, only $1,000.00 of its authorized capital stock was paid in cash, and the officers and stockholders postponed from time to time the issuance of the remaining capital stock . . . and funds for capital investments and operations were advanced by W. R. Long, trading as Long Supply Company, and subsequently Long Supply Company, Inc., and it was from advancements from this source that the Long Manufacturing Company, Inc. purchased the necessary land, buildings, machinery and equipment to carry on its business and said funds have never been paid but are still carried . . . as advances from the Long Supply Company, Inc. . . .

The resolution stated as further reasons the obligation of the Long Supply Company to discharge its debt and the need for additional working capital.

By February 6, 1961, Long, J. G. Long and Mary Ellen Forbes, Long's sister to whom he had earlier transferred one of his seven shares, had applied for the additional shares to which they were entitled and had deposited $59,400, $9900, and $9900 respectively with the corporation in payment for them. Gaines did not have $19,800 with which to purchase the stock to which he was entitled.

On February 6 Gaines obtained a temporary restraining order against the issuance of the stock. On the following day a summons was served on the Long Manufacturing Company, its directors, officers, and stockholders in an equity action brought by Gaines in which he asked that the defendants be permanently restrained and enjoined from issuing the additional capital stock. Thereafter, on March 20, 1951, a summons was issued in a second case in which Gaines asked that the same defendants be directed by a court of equity to declare and pay a dividend to the extent of "the whole of the accumulated profits . . . or such part thereof as the court [should determine] . . . , either in cash or by way of a stock dividend" and that a complete audit of the books be ordered.

Gaines contended in these actions that the company had no need for additional working capital and that the company could at any time pay its indebtedness to Long Supply Company out of its cash on hand without depleting its current assets below $251,792.18, a more than ample amount of working capital. He further alleged that additional capital would overcapitalize the company, leaving it with considerable idle funds for much of the year. Gaines charged that "the adoption of [the] stock issuance resolution was nothing but the culmination of an agreement on the part of . . . Long and Forbes, in bad faith, and in breach of their trust as officers and directors . . . to render . . . [his] stock . . . practically valueless . . . and to make it impossible for . . . [him] to continue his ownership in Long Manufacturing [and] to deprive him of the value of his stock. . . ."

The trial court overruled the defendants' demurrers in each case, and the Supreme Court of North Carolina affirmed these actions in two opinions. In the case concerning the issuance of the new stock the court expressed the view that the fiduciary duty of the majority to the minority is such that the plaintiff might succeed in his action if he could prove, as he had alleged, that the resolution was undertaken not for the corporation's benefit or in its interest but as a means of oppressing the plaintiff and destroying or forcing the sacrifice of his interest in the corporation.

Similarly, the court held in the dividend case that the plaintiff's allegations of a wrongful withholding of dividends entitled him to a chance to prove them. The court expressed the willingness of a

court of equity to intervene on a minority shareholder's behalf where dividends are arbitrarily, oppressively, or wrongfully withheld.

After these decisions, a settlement was reached whereby Gaines's two shares of stock were purchased for about two-thirds of their book value. (Letter from Joseph C. Moore, Attorney for the Plaintiff, Sept. 25, 1959.)

Case No. 4

Matteson v. *Ziebarth*, 40 Wash.2d 286, 242 P.2d 1025 (1952).

This case illustrates the successful elimination of a minority shareholder by the merger route. The squeeze-out here involved was not primarily for the purpose of enriching the majority shareholder but was occasioned by an offer from an outside source, the acceptance of which required that all the shareholders be willing to grant an option on the shares which they owned. The plaintiff in this case by refusing his consent to this transaction invited his elimination as a common shareholder. The case also contains some evidence of a private benefit accruing to the majority shareholder as a result of the acceptance of the offer made. In addition, the majority shareholder's arrangement whereby he put all the minority shareholders except the plaintiff in a position to benefit from the acceptance of the offer by the new corporation is worthy of mention as an example of his good faith in eliminating only the dissenting plaintiff.

The Ziebarth Corporation, a Washington corporation, was organized in 1946 by Archibald R. Matteson and Robert Ziebarth to produce and sell a powdered bleach under the name "Snowy Bleach." The authorized capital was set at 50,000 shares of a par value of $1.00 each, and 11,201 shares were issued in the following manner: Matteson, 3600 shares in return for his interest in the original formula and other assets; Ziebarth, 7600 shares for cash; and F. A. LeSourd, one qualifying share for $1.00 cash. In subsequent years additional shares of stock were issued and, during the period leading up to and at the date of the merger complained of, the stock of the corporation was owned as follows:

Robert Ziebarth	27,200 shares
Archibald Matteson	3,600 shares
Robert Denker	2,675 shares
Lester Swank	175 shares

Fred B. Hurd	100 shares
H. W. Ziebarth	100 shares
F. A. LeSourd	1 share
total common stock outstanding	33,851 shares

The corporation employed Matteson on a fulltime basis at a salary of $150 per month (later $225) until January, 1948, when financial retrenchment became necessary and he withdrew and entered the real estate business. Thereafter he did not take much active interest in the enterprise. Ziebarth devoted about half of his time to sales promotion work for the corporation. He drew a total of less than $500 as salary from the company and nothing at all after 1947. Moreover, he spent substantial amounts of his personal funds in traveling on the company's behalf and continued throughout the corporation's existence to work actively for its success. Ziebarth began in 1947 to attempt to secure additional capital or to find a purchaser for the corporation. He did not have much immediate success in either of these endeavors.

The corporation's earnings history was as follows:

year	*earnings (loss)*
1946 (six months)	($2,567.20)
1947	(9,393.96)
1948	(1,760.86)
1949	(1,366.86)
1950 (January-May)	(681.46)
total	($15,770.34)

From January through May, 1950, the corporation's sales averaged approximately $1,000 per month. As of May 31, 1950, the company had tangible assets of $7,203.31, including cash in the amount of $2,563.80, and liabilities of $104.70. Its entire balance sheet read as follows:

assets:		
current assets:		
cash		$2,563.80
receivables		139.00
inventories:		
finished goods	$ 377.31	
raw materials	1,687.70	

packing materials	1,631.23	
advertising materials	420.50	4,116.74
total current assets		$6,819.54
fixed assets		383.77
total assets		$7,203.31
liabilities & capital:		
liabilities	$ 104.74	
capital	7,098.57	
total liabilities & capital		$7,203.31

outstanding and issued shares of stock = 33,851 shares
book value per share = $2.09

In April, 1949, Ziebarth approached the Gold Seal Corporation, a large marketer of household chemical products. He found that Gold Seal was not willing to invest in the product "Snowy Bleach" without some experience which would lead them to believe that the product could be successfully developed and promoted. Gold Seal was not interested in an immediate purchase of Ziebarth Corporation's stock but made a proposal which was attractive to Ziebarth. It proposed to take for $100 consideration an option on the company's stock for a period of twenty months, during which time it would invest approximately $250,000 in the development and promotion of "Snowy Bleach." The option price for the stock was to be $100,000 or 25 per cent of the net profits before taxes for the sales of "Snowy Bleach" prior to January 1, 1952, whichever sum was greater. If Gold Seal chose not to exercise its option it would nevertheless give to the Ziebarth Corporation any business it had developed for the product, would agree not to compete in the powdered bleach business for three years, and would allow Ziebarth Corporation to use the package it planned to design. In addition, it offered to employ Ziebarth as the manager of its bleach division for eight months at a salary of $2,000 per month for two-thirds of his time, with the understanding that this arrangement would be extended for sixteen months if Gold Seal should so desire.

Ziebarth indicated to Gold Seal that he was willing to accept the offer, and he set out to obtain the consent of the minority stockholders. He began performing services for Gold Seal Corporation and, on April 1, 1950, commenced drawing the $2,000 per month

salary which had been offered in connection with the deal that was to be made. On May 1, 1950, the proposed agreement between Ziebarth Corporation and Gold Seal was submitted to a stockholders' meeting. All the shareholders except Matteson approved the agreement. Matteson objected on the grounds that Ziebarth was receiving a private benefit from Gold Seal in the form of salary while the other stockholders were not to receive any monetary consideration for their options. He maintained that the salary payments were in effect part of the consideration paid by Gold Seal for the agreement and that all the stockholders should therefore be permitted to share in them.

Because Gold Seal's offer was conditioned on its receiving an option to purchase all the stock of Ziebarth Corporation, Matteson's participation was essential. He remained adamant under pressure from Ziebarth and LeSourd, the firm's attorney, but at one point indicated that he would be willing to go along in return for 25 per cent of Ziebarth's salary payments. Ziebarth wrote him a letter outlining why the transaction was the only salvation for the company and concluded by warning Matteson that the other stockholders might find a way to consummate the transaction without him.

Ziebarth was advised that under the law of the State of Washington a two-thirds majority of the shareholders could sell or merge the corporation, with protection afforded the minority through appraisal rights. A merger was decided upon for the purpose of eliminating the dissenting minority shareholder Matteson. Accordingly, Snowy, Inc., was organized on May 17, 1950, with an authorized capitalization of 100,000 shares of common stock at 30 cents par value, and 100,000 shares preferred nonvoting 4 per cent redeemable stock at 20 cents par value. The common stock was issued as follows: Robert Ziebarth, 30,150 shares, H. W. Ziebarth 100 shares, and F. A. LeSourd 1 share. Thus, the issued and outstanding common stock of Snowy, Inc., was equal to the number of outstanding shares of Ziebarth Corporation minus the shares owned by Matteson. The purpose of this arrangement was to assure that each share of Snowy stock would represent a share of Ziebarth Corporation stock with a proportionate share of that equity which Matteson was to lose in the merger added. The preferred stock of Snowy, Inc., was to be issued for the common stock of Ziebarth corporation on a share-for-share basis.

On May 18, 1950, the directors of Snowy, Inc., and of Ziebarth Corporation approved the merger of the two firms. One director of the Ziebarth Corporation, Robert Denker, a minority shareholder, voted against the merger. On the same day, Robert Ziebarth sent letters to Denker, Lester Swank, and Fred B. Hurd, minority shareholders in Ziebarth Corporation who were in danger of being squeezed out along with Matteson, in which he gave them options to purchase common stock of Snowy, Inc., from him at 30 cents per share in amounts equal to their holdings in the Ziebarth Corporation. This option was to be exercised prior to January 10, 1952. The effect of this option would, of course, be to preserve for these minority shareholders the same right to share in the benefits of the Gold Seal deal that they would have had if the Ziebarth Corporation had been able to carry it out.

On May 31, 1950, the shareholders of Ziebarth Corporation approved the merger by the necessary two-thirds vote, with Matteson the sole dissenter. The shareholders of Snowy, Inc., then approved the merger, which was then executed and filed. Following the merger, Snowy, Inc., and its common shareholders executed with Gold Seal Corporation an agreement which was substantially in the terms of the original offer presented to Ziebarth Corporation. On June 5, 1950, Robert Ziebarth, H. W. Ziebarth and F. A. LeSourd, as all the common stockholders of Snowy, Inc., signed an agreement giving Gold Seal Corporation an option to purchase all the common stock of Snowy, Inc., for $100,000. This agreement also provided that Ziebarth was to be employed for the months of April through November, 1950, at $2,000 per month for two-thirds of his time.

On June 12, 1950, Matteson filed suit to have the merger agreement between Ziebarth Corporation and Snowy, Inc., decreed void and of no effect.

The trial court dismissed the action with prejudice, and the Supreme Court of Washington affirmed this judgment. On appeal, Matteson contended that the merger was illegal because Snowy, Inc., had been formed for the express purpose of merging with and absorbing Ziebarth Corporation. The supreme court held that this was a lawful business purpose within the meaning of the Corporation Act. It then further held that there was no illegality in the issuance of callable preferred stock in the surviving corporation for the common stock of Ziebarth Corporation. The court went on to hold

that, in the absence of actual fraud, the sole remedy of a shareholder who objects to a merger plan is his right to have his shares appraised and purchased under the Corporation Act, at least in cases such as this where he had full knowledge of the facts at the time that the plan was approved by the stockholders. The court considered whether Ziebarth's employment contract at $2,000 per month was actual fraud and held that no fraud had been shown. The court further held that neither the valuation of the shares of Ziebarth Corporation at 20 cents nor the action of Ziebarth in granting options to the other minority stockholders nor any other aspect of the case indicated the fraud necessary to justify the granting of equitable relief.

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